



Calhoun: The NPS Institutional Archive
DSpace Repository

Theses and Dissertations

1. Thesis and Dissertation Collection, all items

1981

A historical analysis of internal review.

Lancaster, Donald D.

Monterey, California. Naval Postgraduate School

<http://hdl.handle.net/10945/20547>

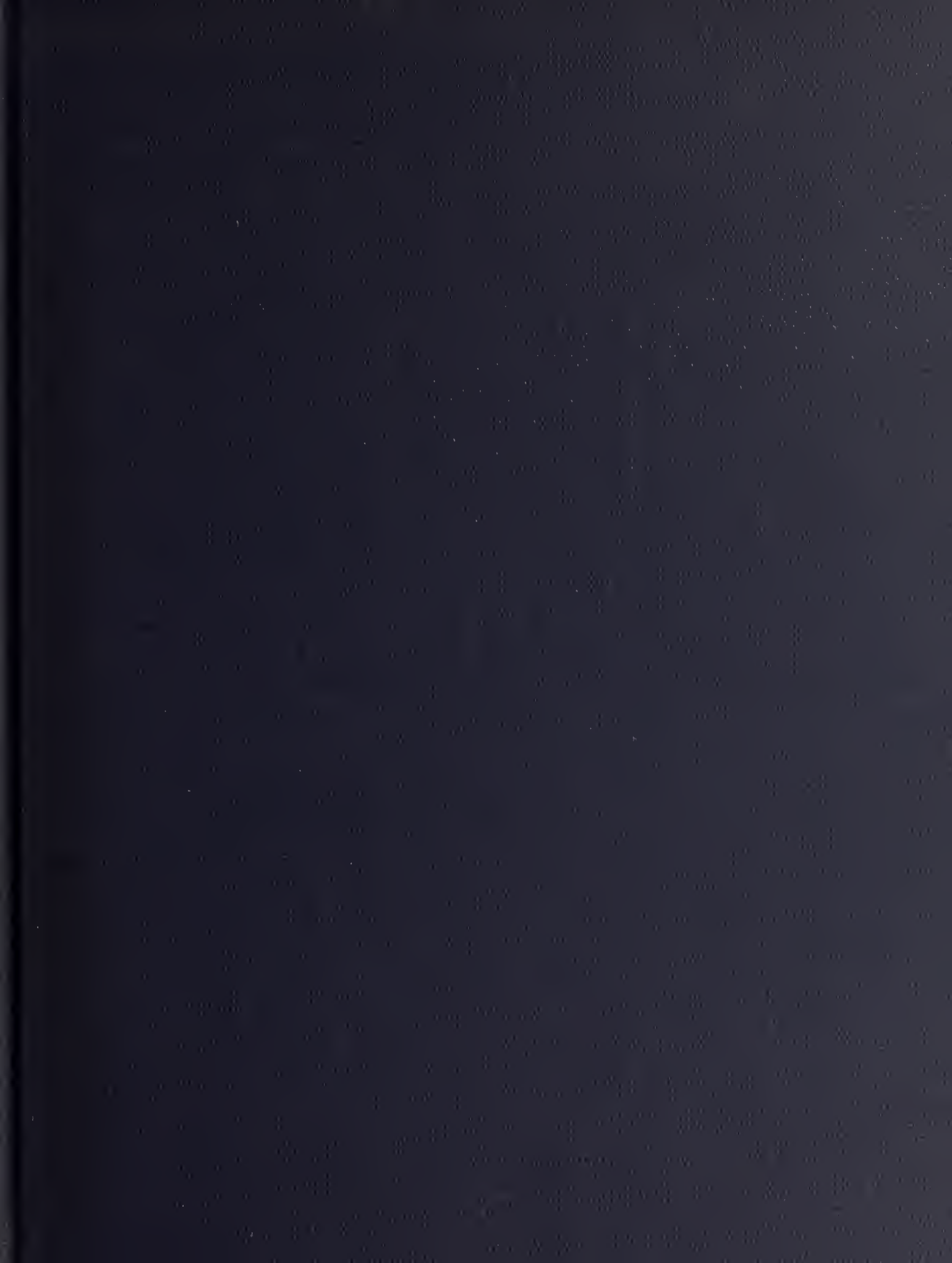
Downloaded from NPS Archive: Calhoun



Calhoun is the Naval Postgraduate School's public access digital repository for research materials and institutional publications created by the NPS community. Calhoun is named for Professor of Mathematics Guy K. Calhoun, NPS's first appointed -- and published -- scholarly author.

Dudley Knox Library / Naval Postgraduate School
411 Dyer Road / 1 University Circle
Monterey, California USA 93943

<http://www.nps.edu/library>



27.11.1971 1. 1. 1972
28.11.1971 2. 1. 1972
29.11.1971 3. 1. 1972

NAVAL POSTGRADUATE SCHOOL

Monterey, California



THESIS

A HISTORICAL ANALYSIS OF INTERNAL REVIEW

by

Donald D. Lancaster, Jr.

March 1981

Thesis Advisor: R. A. Bobulinski

Approved for public release; distribution unlimited

T199175

REPORT DOCUMENTATION PAGE		READ INSTRUCTIONS BEFORE COMPLETING FORM
1. REPORT NUMBER	2. GOVT ACCESSION NO.	3. RECIPIENT'S CATALOG NUMBER
4. TITLE (and Subtitle) A Historical Analysis of Internal Review		5. TYPE OF REPORT & PERIOD COVERED Master's Thesis March 1981
		6. PERFORMING ORG. REPORT NUMBER
7. AUTHOR(s) Donald D. Lancaster, Jr.		8. CONTRACT OR GRANT NUMBER(s)
9. PERFORMING ORGANIZATION NAME AND ADDRESS Naval Postgraduate School Monterey, California 93940		10. PROGRAM ELEMENT, PROJECT, TASK AREA & WORK UNIT NUMBERS
11. CONTROLLING OFFICE NAME AND ADDRESS Naval Postgraduate School Monterey, California 93940		12. REPORT DATE March 1981
		13. NUMBER OF PAGES 197
14. MONITORING AGENCY NAME & ADDRESS (if different from Controlling Office)		15. SECURITY CLASS. (of this report) Unclassified
		15a. DECLASSIFICATION/DOWNGRADING SCHEDULE
16. DISTRIBUTION STATEMENT (of this Report) Approved for public release; distribution unlimited.		
17. DISTRIBUTION STATEMENT (of the abstract entered in Block 20, if different from Report)		
18. SUPPLEMENTARY NOTES		
19. KEY WORDS (Continue on reverse side if necessary and identify by block number) Internal Review, Internal Auditing, Internal Control, Auditing		
20. ABSTRACT (Continue on reverse side if necessary and identify by block number) Internal review is the local commander's in-house audit function; and as such forms an important part of the local commander's system of management controls. Recently, increased emphasis has been placed on internal review because of the increased awareness of the need to manage accountable resources, and the internal review function's potential for improving the economy,		

efficiency, and effectiveness of operations. This thesis examines the history and development of auditing in general and internal review in particular, presents the current status of internal review in the Department of Defense, and analyzes the effectiveness of current programs. Five alternatives of internal review organization are analyzed for effectiveness, and a decentralized but hierarchical organization proposed for implementation. Other recommendations include organizing the internal review function in a direct staff relationship to the local commander, and the placement of local audit boards under the direct supervision and management of the internal review function.

Approved for public release; distribution unlimited

A Historical Analysis of Internal Review

by

Donald D. Lancaster, Jr.
Lieutenant, Supply Corps, United States Navy
B.S., Northeast Louisiana University, 1971

Submitted in partial fulfillment of the
requirements for the degree of

MASTER OF SCIENCE IN MANAGEMENT

from the

NAVAL POSTGRADUATE SCHOOL
March 1981

ABSTRACT

Internal review is the local commander's in-house audit function; and as such forms an important part of the local commander's system of management controls. Recently, increased emphasis has been placed on internal review because of the increased awareness of the need to manage accountable resources, and the internal review function's potential for improving the economy, efficiency, and effectiveness of operations. This thesis examines the history and development of auditing in general and internal review in particular, presents the current status of internal review in the Department of Defense, and analyzes the effectiveness of current programs. Five alternatives of internal review organization are analyzed for effectiveness, and a decentralized but hierarchical organization proposed for implementation. Other recommendations include organizing the internal review function in a direct staff relationship to the local commander, and the placement of local audit boards under the direct supervision and management of the internal review function.

TABLE OF CONTENTS

I.	INTRODUCTION	10
A.	GENERAL	10
B.	OBJECTIVE	19
C.	METHODOLOGY	19
D.	ORGANIZATION	20
II.	BACKGROUND AND PERSPECTIVE	22
A.	GENERAL	22
B.	TYPES OF AUDIT	32
1.	General	32
2.	Public Sector	33
a.	General	33
b.	Three Basic Types	34
c.	Other Types	34
d.	Financial and Compliance	36
e.	Economy and Efficiency	37
f.	Program Results	38
3.	Summary	39
C.	LEVELS OF AUDIT	40
1.	General	40
2.	External Auditing	41
a.	Private Sector	41
b.	DON	43

3.	Internal Auditing	-----	43
a.	General	-----	43
b.	Authority	-----	45
c.	Purpose	-----	45
d.	Organization	-----	46
e.	Concentration	-----	46
4.	Internal Review	-----	47
a.	General	-----	47
b.	Authority	-----	49
c.	Purpose	-----	50
d.	Organization	-----	50
e.	Concentration	-----	50
f.	Summary	-----	52
D.	BENEFITS OF INTERNAL REVIEW	-----	53
1.	General	-----	53
2.	Characteristics of Internal Review	---	53
3.	Benefits of Internal Review	-----	59
E.	REQUIREMENTS OF INTERNAL REVIEW	-----	66
1.	Organization	-----	67
2.	Staffing	-----	68
3.	Work Performance	-----	69
4.	Command Support	-----	70
F.	SUMMARY	-----	71
III.	STATUS OF INTERNAL REVIEW	-----	72
A.	INTRODUCTION	-----	72
B.	GENERAL	-----	74

C.	INTERNAL REVIEW IN THE DEPARTMENT OF THE ARMY (DA) -----	77
1.	History -----	77
2.	Current Organization -----	78
3.	Staffing -----	83
4.	Work Performance -----	86
5.	Summary -----	89
D.	INTERNAL REVIEW IN THE DEPARTMENT OF THE AIR FORCE -----	90
1.	General -----	90
2.	Organization -----	90
3.	Staffing -----	92
4.	Work Performance -----	93
5.	Summary -----	95
E.	INTERNAL REVIEW IN THE U.S. MARINE CORPS --	96
1.	General -----	97
2.	History -----	97
3.	Organization -----	103
4.	Staffing -----	104
5.	Work Performance -----	106
6.	Summary -----	107
F.	INTERNAL REVIEW IN THE U.S. NAVY -----	108
1.	Background -----	108
2.	Organization -----	111
3.	Staffing -----	115
4.	Work Performance -----	121
5.	Summary -----	127

G.	SUMMARY	-----	128
IV.	ANALYSIS OF CENTRALIZATION/DECENTRALIZATION	---	136
A.	INTRODUCTION	-----	136
B.	PROBLEM	-----	137
C.	ALTERNATIVES	-----	138
D.	CRITERION OF CHOICE	-----	139
E.	EFFECTIVENESS	-----	140
F.	EVALUATION OF ALTERNATIVES	-----	143
1.	First Order Analysis	-----	143
2.	Second Order Analysis	-----	151
G.	SUMMARY	-----	157
V.	CONCLUSIONS AND RECOMMENDATIONS	-----	160
A.	INTRODUCTION	-----	160
B.	GENERAL	-----	162
C.	AMPLIFICATION OF ALTERNATIVE	-----	166
1.	Local Organization and Staffing	-----	166
2.	Department Organization	-----	173
3.	Definition of Secondary Responsibilities		176
D.	IMPLEMENTATION IN THE DON	-----	180
E.	SUMMARY	-----	184
APPENDIX A	INTERNAL REVIEW IN THE U.S. MARINE CORPS - SURVEY QUESTIONNAIRE	-----	188
APPENDIX B	INTERNAL REVIEW TRAINING COURSES	-----	191
	LIST OF REFERENCES	-----	193
	INITIAL DISTRIBUTION LIST	-----	197

LIST OF FIGURES

FIGURES

II-1	EXTERNAL AUDITING & INTERNAL AUDITING AND THEIR RELATIONSHIP TO INTERNAL REVIEW	42
III-1	U.S. ARMY INTERNAL REVIEW ORGANIZATION	79
III-2	INTERNAL REVIEW STAFFING IN THE DEPARTMENT OF DEFENSE	85
III-3	INTERNAL REVIEW TRAINING COMPARISON OF USA AND USN	87
III-4	INTERNAL AUDIT STAFFING IN THE DEPARTMENT OF DEFENSE	94
III-5	USMC INTERNAL REVIEW STAFFING	98
III-6	USMC INTERNAL REVIEW ORGANIZATION	99
III-7	USMC INTERNAL REVIEW WORK PERFORMANCE	100
III-8	USMC INTERNAL REVIEW REPORTING	101
III-9	ORGANIZATIONAL POSITION OF USN INTERNAL REVIEW FUNCTION	114
III-10	GRADES OF PERSONNEL ASSIGNED TO USN INTERNAL REVIEW FUNCTIONS	119
III-11	SUMMARY OF CHARACTERISTICS OF USN ACTIVITIES WITH INTERNAL REVIEW FUNCTIONS	120
III-12	EFFECTIVENESS OF INTERNAL REVIEW IN THE DEPARTMENT OF DEFENSE	135
V-1	PROPOSED ORGANIZATION OF LOCAL INTERNAL REVIEW FUNCTION	172

I. INTRODUCTION

A. GENERAL

"For the want of a nail, . . ." This often quoted parable cleverly summarizes the results of inadequate resources or, perhaps more properly, the delayed reaction to the inadequate management of resources. Today's commanders, commanding officers and officers-in-charge of United States Armed Forces are being challenged to accomplish expanded mission objectives while holding constant, or even decreasing, the amount of resources used. This observation is evidenced by the following quotation from Major Michael E. Thorn, USAF who was the Air Force Cost Analyst of the Year of 1976:

"There can be little argument over the proposition that the military is competing for natural resources - on a scale it has never before encountered. Although mission requirements are increasing, the critical supporting elements of money, material, and manpower, are in short supply. In addition, there is little, if any, relief in sight. This dilemma has placed a premium on the effective management of allocated resources at all levels of the military." [1]

As further evidence of the "classic" proportions of the military's resource management problem, consider the following remarks made recently by the Honorable Robert C. Moot, former Assistant Secretary of Defense (Comptroller):

"We are seeing a classic budget problem. At the same time that we have significant pressure for a stronger national defense posture we have the counterpressure for a balanced budget. The two objectives are competitive and in the attempt to satisfy both, the effect on Military Readiness can be devastating." [2]

The above remarks and observations are, in effect, summarized by the following excerpt from a recent speech by Mr. Cordell Smithfield, Senior Cost Analyst Headquarters, U.S. Army

Transportation Command:

"The common goal at every level and location within the Services is a technologically advanced, strongly manned, well equipped and thoroughly trained force, ready to perform its mission at any time, any place. Unfortunately, we exist in an environment today in which the successful attainment of this goal is becoming more and more difficult. On the one hand we are faced with an array of ever increasing requirements driven by shifting threats, changing technology, and serious modernization needs, and on the other hand with concurrently decreasing resources driven by social or congressional attitudes and rapidly rising unpredictable inflation." [3]

The high visibility attached to the problem of resource management and its relationship to the topic of this thesis is expressed by the following remarks by Congressman Brooks, Chairman of the Subcommittee on Legislation and National Security of the House Committee on Government Operations:

"During this and the previous Congress, we have devoted a great deal of attention to reviewing the adequacy and effectiveness of the Department's (of Defense) internal management controls . . . During the past three years we have made extensive reviews of many of the Department's (of Defense) audit activities." [4]

The basic response of the U.S. Navy (USN) to the overall problem of resource management described above was

the implementation of the Planning, Programming and Budgeting System (PPBS) in 1961 under the direction of then Secretary of Defense Robert McNamara. [5:37]

Davis Novick, the "father of program budgeting" [5:40] states:

"The primary reason for program budgeting is that it provides a formal, systematic method to improve decisions concerning the allocation of resources. Obviously, these allocation problems arise because available resource supplies are limited in relation to the demands for them." [5:48]

The Budgeting phase of PPBS was carried out in the traditional incremental manner until the forced introduction of the Zero Based Budgeting approach for the submission of the Fiscal Year 1978 Operations and Maintenance, Navy, appropriation. This requirement was not levied upon the USN by President Carter's reforms as is commonly thought by some; but by the Senate Appropriations Committee who, dissatisfied with a perceived inadequacy in the normal justification books, called for the strawman zero base submission cited above.

[6:C-67]

Dennis S. Ippolito has explained the difference between the "traditional" incremental and the "new" zero based approach as follows:

"Budgeting in the United States has traditionally been incremental - that is, budget review has been primarily concerned with the funds requested above the current level of spending. Under incremental budgeting, most agencies and programs have a base - that is, a certain commonly accepted activities and expenditures - which is continued from year to year and is not ordinarily

subject to detailed review. There is, as a consequence, a high degree of stability and continuity (emphasis added) from one year's budget to the next. Over time, the incremental changes that are made can have a dramatic cumulative effect, but the room for immediate maneuver is limited.

Zero-base budgeting, on the other hand, requires detailed examination of the entire budget, not just the increment. Its emphasis on comprehensiveness means that the same scrutiny must be applied to all programs and agencies, regardless of their longevity, legislative mandates, and past commitments. No prior assumptions are made about the justification for or inviolability of an agency's base. Indeed, each agency has a 'zero base.' If effect, zero-base budgeting simply requires that all items in the budget be reexamined each time a new budget is prepared.

To achieve this general objective, a zero-based system requires that certain kinds of information be collected and that specific analytical tasks be performed. For each discrete activity within an agency, descriptions and justifications, goals and objectives, and performance measurement standards must be provided." [7:193-194]

Implicit in the PPBS is a system of management controls during the budget execution phase. Robert N. Anthony has defined "Management Control" as " . . . the process by which management assures that the organization carries out its strategies effectively and efficiently." [8:3]

Since "efficiency is the ratio of outputs to inputs" [8:5], and "effectiveness is the relationship between . . . outputs and . . . objectives" [8:5], and the term "inputs" is synonymous with "resources"; it follows, by Anthony's definition, that an effective management control system is of paramount importance to resource management and therefore mission objectives.

As the head of an activity, the commanding officer, by definition, directs the system of management and operational controls and is responsible to higher authority for the proper functioning of his or her activity including effective and efficient resource management. Most operational controls such as the type of forms to be used and the various routine procedures to be followed, are established by higher echelons and it is the responsibility of the local commander to ensure their proper execution. The methods employed to ensure the proper execution of operational controls and the efficient use of scarce resources, in effect and by definition, constitute a management control system. [8:2-3]

One of the components of any management control system is the ability for self-inspection of operational controls and other management controls. [8:444] This self-inspection has been an integral aid to management since antiquity, but was first recognized as a "profession" in the private sector in 1941 with the establishment of the Institute of Internal Auditors, Inc. The U.S. Government in general and the USN in particular, first formally recognized the role of internal audit as a result of the National Security Act Amendments of 1949 (10 U.S.C. 5061) and the Budget and Accounting Procedures Act of 1950 (31 U.S.C. 66a); which provided the statutory authority (and requirement) for the establishment and conduct of internal audit.

The concept of internal audit envisioned under the above legislation was (and still is) that of an agency or department-wide organization reviewing the operations of that agency or department as a whole. Internal review is an extensive of this philosophy to the "local command" or "field activity" level of operations within a particular agency or department.

Prior to 1976 however, the only guidance regarding internal review in the USN was set forth in the Navy Comptroller Manual Volume I which defined internal review as a comptrollership function consisting of eight functions closely related to financial comptrollership or liaison with the Naval Audit Service (NAVAUSDVC).

In 1976, with the issuance of Secretary of the Navy Instruction (SECNAVINST) 7510.8 dated 15 October 1975 entitled: "Internal Review in the Department of the Navy," the Navy formally implemented internal review and broadened its scope to include areas outside of financial comptrollership, such as any areas subject to inefficiency, misapplication of funds, fraud or theft. SECNAVINST 7510.8 reflected the USN's basic philosophy that internal review is an essential element of a commanding officer's system of management control within his or her activity [9], by defining the objective of internal review as follows:

"The objective of the Internal Review function is to aid the Commander, Commanding Officer or Comptroller in their role as funds administrators by assessing the

fidelity with which prescribed procedures are being followed for the accounting and expenditure of appropriated and non-appropriated funds." [10:2]

In consonance with this philosophy, SECNAVINST 7510.8 tasked various headquarters commands with issuing supplemental instructions to subordinate commands, and tasked the USN's Auditor General to develop and conduct the requisite training and provide technical guidance to internal reviewers. This action was taken in order to develop a management control capable of providing the following benefits which were extracted from a review of professional literature:

1. Internal review is a strong flexible management control tool of basically unlimited scope, which the Commander can use at his or her discretion.
2. Internal review is responsible directly to line management, not to outside agencies.
3. Internal review allows the Commanding Officer to concentrate effort and expertise on areas within his or her cognizance which are suspect of, or susceptible to efficiency, ineffectiveness, fraud, over-expenditure, questions of fact; or areas too financially complex to permit a rapid assessment by the Commanding Officer as a layman.
4. If well done, the work of an internal review function will not be duplicated (but will be built upon) by outside agencies, specifically the General Accounting Office (GAO) or the Naval Audit Service (NAVAUDSVC).
5. Independent internal review affords harried line management an excellent opportunity to "get out of the trees and look at the forest."
6. Internal review serves as an expert flexible advisory staff to the Commanding Officer.

7. Internal review has the propensity to identify legitimate dollar savings which line management can apply to other areas.

8. "Internal review augments the commander's ability to respond immediately to warning indicators within the command by performing evaluations of command programs, procedures and operations; especially those related to expenditures of funds, use of resources and the control of command property, material and supplies." [11:118]

9. Internal review can serve as the commander's focal point, clearinghouse and follow-up reviewer for previous audits by external sources or previous internal reviews; and as liaison with external audit agencies.

In short, if properly organized, staffed and executed, internal review could provide invaluable aid to line management in many areas and serve as an extension or alter ego of the commanding officer.

The benefits to be obtained from internal review are unfortunately dependent on and subject to the following limitations and/or constraints which were extracted from professional literature:

1. The scope of internal review is a direct function of the organization's objectives and the resources available to accomplish those objectives.

2. The detail and breadth of analysis possible varies directly with the resources available or the quality of those resources.

3. The cost of internal review varies directly with the degree of detail, frequency of review and breadth of analysis desired.

4. Internal review is particularly sensitive and susceptible to a lack of command support or lack of resources.

5. Internal review can be severely limited by a lack of independence, or even the appearance of less than total independence.

6. Internal review, if not the beneficiary of the requisite support and/or resources, might not be accomplished at all.

The problem with internal review in the U.S. Navy, as perceived by the author, is one of ineffectiveness as a result of a combination of the limitations and/or constraints listed above. That this perception is not unique, is supported by the recent actions of the NAVAUDSVC, which included a review of the internal review program during its fiscal year 1979 audits [9] and concluded:

"The policies outlined in SECNAVINST 7510.8 are only being partially accomplished. Many Naval activities have not established an internal review program and many of those that have, limit the scope of the internal review staff to areas not directly related to mission accomplishment." [9:3]

In addition, the Task Force on Evaluation of Audit, Inspection and Investigative Components of the Department of Defense included seven recommendations specifically addressing the internal review function in its report to the Congress and the Secretary of Defense dated 1 May 1980. [11]

Given the relative infrequency of external audit visits and the increasing visibility of efficient resource management, the internal review function will become increasingly vital to the local commander in executing his or her responsibility as an accountable resource manager.

The task to the USN, and of this thesis, is to determine the best method of accomplishing effective internal review.

B. OBJECTIVE

The purpose of this thesis is to determine the best method of accomplishing internal review in the USN. The objectives therefore are:

1. Determine the degree of compliance with current directives and preferred practices in the USN.
2. Determine the underlying causes of non-compliance.
3. Examine alternatives to improve the effectiveness of internal review.
4. Make recommendations as to which alternative offers the best probability of increasing the effectiveness of internal review in the USN.

C. METHODOLOGY

First, a literary search was conducted to establish the current policies and prescribed practices for internal review in the USN. The search also attempted to ascertain the current degree of compliance within the USN and included USN and Department of Defense (DOD) regulations and reports as well as relevant professional journals, periodicals and textbooks from private sector literature.

Next, alternatives for the conduct of internal review were defined, and the advantages and disadvantages of each listed.

Then, measures of effectiveness and an effectiveness model were defined for the internal review function.

The various alternatives were analyzed based on the above model and the results evaluated and presented.

Finally, conclusions were drawn and recommendations offered.

D. ORGANIZATION

The thesis is divided into five chapters. Chapter I is introductory in nature and provides an overview of the subject and the rationale for the thesis.

Chapter II discusses the field of auditing in general as a means of providing background to the reader. It then differentiates the internal review function from the other levels of audit in order to provide the reader with a perspective on the role of internal review. The relationship of internal review to other, more familiar types of auditing such as Financial and Compliance, Economy and Efficiency and Program Results are discussed, as are the benefits to be gained from effective internal review.

Chapter III describes the current status of internal review in the Department of Defense (DOD), identifying major problem areas such as existence, staffing, organization and performance.

Chapter IV defines the problems of internal review in a more classic "problem-solving" manner; and proceeds to define alternatives, measures of effectiveness; and show the analysis conducted.

Chapter V presents the results of the analysis, and evaluates these results. Conclusions from these results are presented and recommendations for improving the effectiveness of internal review are made.

II. BACKGROUND AND PERSPECTIVE

A. GENERAL

In order to accomplish the stated objectives of the thesis, it is first necessary to provide the reader with definitive background material on the history and development of the function entitled internal review. An understanding of the development and purposes of auditing in general, and internal review in particular; will serve to provide the reader with the intuitive perspective necessary to understand the various aspects of an effective internal review program.

Accordingly, the purpose of this chapter is to clarify, through the use of narrative descriptions and comparisons, the role of internal review; and its relationship to more familiar types of auditing. Additionally, this chapter will seek to define what internal review should be and what it should not be, in order to provide a basis, or standard, of measurement from which to judge the current effectiveness of internal review within the Department of the Navy (DON).

"Internal review" is a relatively recent nomenclature for the long established practice of organizations auditing themselves in order to identify and correct inefficiency and ineffectiveness in their operations and control systems. This practice of self-inspection is more commonly described as "internal" auditing in order to differentiate it from the

"external" auditing performed by entities independent of the organization being scrutinized. Thus, the definition of internal review relative to other forms of audit or inspection is more one of "who conducts the audit," rather than the audit's substance.

To trace the beginnings of auditing, one must travel back in time to the third millennium B.C., where archaeologists have unearthed evidence of the preparation of summary lists of transactions by Mesopotamian scribes, who then compared these lists to the original lists prepared by others. The evidence shows tiny dots, ticks and circles on the sides of figures; which leads one to the belief that this was the beginning of two control devices: division of duties and systematic checking. [12]

Other early civilizations such as Egyptian, Persian and Hebrew also required the audit of one's official records by another. The Greeks preferred slaves to freemen as auditors, believing that the statements of a slave under torture were more trustworthy than those of a freeman under oath. [12]

U.S. history provides a stark example of the need for effective auditing and also one of the perennial ploys used to frustrate auditors: "itemize the small expenses to death, and lump all the big ones together." [13] This example is taken from Allen Schick's article "200 Years of

Financial Management," which appeared in the July, 1976 bicentennial edition of Armed Forces Comptroller. [13] It is paraphrased for brevity with direct quotations indicated. Mr. Schick states that "War . . . has been one of the driving forces in the upward path of federal spending." As a prelude to a discussion of the relationship of war and money, Mr. Schick offers as an example of the need for effective scrutiny of public spending the following recounting of the financial prosecution of the American Revolution: " . . . it all began with a General. General George Washington was not only first in war and first in peace, but also first in American budgeting." When offered a tax-free salary of approximately \$6000 (in 1776 dollars) Washington, "dedicated public servant that he was," replies " . . . far be it from me to accept payment in the service of my country; just pay my expenses." When he (Washington) submitted his expense vouchers for payment in 1883 (the conservative estimate of the total in current dollars, is between five and ten million dollars), they included such items as a "gilded coach for Martha, imported wines, servants and a host of similar items." As to the method of enumeration of these necessary expenses, Mr. Schick gives the following examples which were on consecutive pages of Washington's expense account: "Oats for mule - three and one-half cents."; and on the next page, "Sundry and

Miscellaneous Expenses - \$3500." It is obvious that the Continental Congress could have used the General Accounting Office's (GAO) assistance and "watchdog" powers from the beginning.

One cannot state that an effective audit of General Washington's accounts during the course of the Revolution would have precluded the disbursement of public funds in such a vague and perhaps doubtful manner. However, one can assert that such an audit would have certainly discovered the questionable items; and alerted the "authorizing body" to the situation in a timely manner; allowing appropriate action to be taken.

This facet of auditing, bringing questionable transactions to the attention of responsible management, is gaining increasing importance and emphasis today, relative to the more traditional view of auditing which was to "certify the validity of accounts." [12:24] As evidence of this transition from the "green eye-shaded bookkeeper: to the professional auditor as an aid to management, consider the following from a recent GAO report to the Congress [14:1]:

"In recent years the role of Federal internal auditing has been the subject of widespread congressional concern, culminating in the passage of Inspector General legislation in 1976, 1977, 1978, and 1979 which combined the audit and investigation activities within 15 Federal agencies for the purpose of detecting fraud, waste and and abuse (emphasis added). This concern was generated by the public's demand for better Government and an end to waste in Federal programs.

Federal executive agencies have offices throughout the United States and abroad which employ nearly 5 million people and manage scores of programs. Effective management of such operations requires a system of internal control, including internal audit (emphasis added). An agency's internal audit organization, when given adequate staff organizational independence, and authority to review all agency functions, can furnish management with information, analyses, appraisals, and recommendations for improving operations (emphasis added)."

Returning to the history and development of auditing, Lawrence B. Sawyer, CIA (Certified Internal Auditor) has stated:

"The auditing function, as we know it today, started during the Industrial Revolution. Many commercial and industrial organizations employed expert accountants to examine and certify the validity of accounts. Even Columbus, in 1492, was accompanied to America by an auditor representing Queen Isabella." [12:24]

Internal auditing in its modern context, began to emerge as a separate discipline following the Securities Act of 1933 and the Securities Exchange Act of 1934, as amended, which made corporate management responsible for the accuracy of financial statements filed with the U.S. Securities and Exchange Commission (SEC). This requirement led corporate management to hire accountants to make more detailed verifications of accounts than the public (external) accountants could. [12]

It was not until 1941 however, that internal auditing began to gain the prestige and trappings of a separate profession. That year marks the formation of the Institute of Internal Auditors, Inc. (IIA). It was then, that internal

auditing "began to range beyond the books of account and began to assume a new posture." [12:25] 1941 was also, "the year the first major book in the field, Internal Auditing, was published." [15:25]

Victor Z. Brink, CIA, a charter member of the IIA, has recalled the formative pressures and early history of internal auditing as a profession as follows:

"In 1941 there were quite a few Internal Auditing departments but the number was very small in relation to the number of organizations that needed such services . . . There was, at that time, however, an increasing awareness of the growing size and complexity of all kinds of operations by business, government, and other types of organizations.

. . . There was an increasingly common recognition that Internal Auditing departments could make a more important contribution to help management cope with the emerging complexities.

. . . Typically, the existing Internal Auditing departments reported to lower-ranking financial executives - more often to the officer responsible for accounting activities.

. . . 1941 was the year when a small group of forward-looking internal auditors became discontented with the visibility provided by existing professional associations and decided that a new professional organization should be established and dedicated exclusively to the professional interests of internal auditors.

During the years following 1941, and especially after World War II, a number of interrelated forces were at work . . . continuing expansion of the size and complexity of business corporations, governmental bodies, and philanthropic organizations. Business corporations were also becoming increasingly diversified and extended geographically to include more international operations.

The result was additional concerns on the part of management . . . and a related effort to expand and upgrade internal auditing groups. Management also became increasingly aware of getting more benefits from the substantial amounts of money expended to maintain internal auditors and, therefore, was motivated to use them to help solve broader operational problems.

At the same time, internal auditors became increasingly aware of their opportunities to go beyond the narrower protective role and to make more substantial and dynamic contributions to management's welfare. . . This new emphasis of internal auditors, expanding their traditional financial auditing role, came to be known as 'operational auditing'." [15:25-26]

Since 1941, internal auditing as a profession has grown and matured, while expanding its role in serving a wide range of organizational needs, expecially operational activities. This development can be traced by referring to the profession's own Statements of Responsibilities of the Internal Auditor, as promulgated by the IIA.

The original 1947 Statement stated that internal auditing "deals primarily with accounting matters but may properly deal with matters of an operating nature." [12:25]

The revised 1957 Statement expended the role of the internal auditor somewhat by stating that internal auditing provides for "the review of accounting financial, and other operations." [12:25]

The 1971 Statement described internal auditing as "the review of operations as a service to management." [12:25] This served to remove the internal auditor from the tie to the books of account which first spawned the need for internal audits.

In 1978, the internal auditor's role was expanded further by the revision of the 1971 description from "service to management" to the more encompassing "service to the organization." This revision was promulgated by the IIA's Standards for the Professional Practice of Internal Auditing and expanded the service of the internal auditor to the board of directors as well as to management.

[12:25]

This 1978 revision portends much more than is at first obvious. As will be shown later in this thesis, the extension of internal auditing's role and service to a higher echelon than operating management, can be a causal factor in reducing both the use and effectiveness of internal auditing to operating management. This expansion however, in the view of some students of bureaucracy such as W. J. Haga, Phd, is (was) inevitable; and will (has) led to the formation of yet another organizational entity to perform the duties and functions once performed by internal auditing. This quirk of bureaucracy, described by Dr. W. J. Haga in his book, HAGA'S LAW as the "Spin-off Corollary," has had the effect of creating the need for such an entity of function. The organizational function which has developed in the DON to satisfy this need is termed "internal review."

A description of the function and objective of effective internal auditing with respect to operating management is outlined by the IIA's latest Statement of Responsibilities of Internal Auditors which states:

"The objective of internal auditing is to assist all members of management in the effective discharge of their responsibilities by furnishing them with analyses, appraisals, recommendations and pertinent comments concerning the activities reviewed. Internal auditors are concerned with any phase of business activity in which they may be of service to management. This involves going beyond the accounting and financial records to obtain a full understanding of the operations under review. The attainment of this overall objective involves such activities as:

- Reviewing and appraising the soundness, adequacy, and application of accounting, financial and other operating controls, and promoting effective control at reasonable cost.
- Ascertaining the extent of compliance with established policies, plans, and procedures.
- Ascertaining the extent to which company assets are accounted for and safeguarded from losses of all kinds.
- Ascertaining the reliability of management data developed within the organization.
- Appraising the quality of performance in carrying out assigned responsibilities.
- Recommending operating improvements." [15:27]

This chapter has thus far traced both the need and development of auditing in general, and internal auditing in particular, from ancient times to the present. It has been shown that the need for independent verification and appraisal of financial operations dates from the earliest

business activities. It may be stated, that the need for auditing originated the first time a business endeavor expanded beyond the capability of the owner/manager to personally supervise or record all transactions.

It has also been shown, that the development of internal auditing closely parallels the expansion of business enterprises into more complex endeavors and geographically separated locations. This expansion of operations taxed the capabilities of operational management, and led to more and more reliance by management on the advisory and investigative capacities of internal auditing.

It may be postulated at this point, that the forces which drive this increased complexity and scope of operations, such as multi-national governmental regulations and perplexing global economics, will neither moderate nor diminish in the foreseeable future. If history repeats, this will probably have the effect of increasing management's reliance upon, and hence the importance of internal auditing as an aid to effective and efficient operations. This presumption underscores the essentiality of educating line management in the benefits of internal auditing; and of determining the most efficient and effective manner of conducting internal audit.

Accordingly, this chapter will continue with the objective of providing definitive material concerning the types and levels of audit, and the benefits and requirements for effective internal audit or review.

B. TYPES OF AUDIT

1. General

There are numerous definitions of the term "auditing," from the general dictionary description to the specific definition applied to a particular audit program or engagement. Each definition has its place, depending upon the usage of the term. The following definitions have been selected in order to provide the reader with a general knowledge of the term, and with a sense of perspective as to the widespread use of the term.

Webster's New Collegiate Dictionary (1977 edition) defines "audit" as: "(a) a formal or official examination and verification of an account book, (b) a methodical examination and review."

The American Accounting Association (AAA) defines auditing as,

"a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users." [16:4]

The American Institute of Certified Public Accountants (AICPA) in its Statements on Auditing Standards No. 1 (1973) describes financial audit as:

"The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of (financial) operations and changes in financial position in conformity with generally accepted accounting principles. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his examination has been made in accordance with generally accepted auditing standards." [16:6-7]

The Institute of Internal Auditors (IIA) in its Statement of Standards for the Professional Practice of Internal Auditing issued in 1978 describes internal auditing as follows:

"Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed." [16:8]

2. Public Sector

a. General

The above definitions are primarily designed and aimed at the practice of auditing in the private sector of the economy. In the public sector, the first definitive authority is the GAO.

The GAO has defined auditing as follows:

"The term Audit is used to describe not only work done by accountants in examining financial reports but also work done in reviewing (a) compliance with applicable laws and regulations, (b) efficiency and economy of operations, and (c) effectiveness in achieving program results." [17:3]

b. Three Basic Types

The GAO further deliniates the three types of audit stated above as follows:

"(1) Financial and Compliance - determines (a) whether financial operations are properly conducted, (b) whether the financial reports of an audited entity are presented fairly, and (c) whether the entity has complied with applicable laws and regulations.

"(2) Economy and Efficiency - determines whether the entity is managing or utilizing its resources (personnel, property, space and so forth) in an economical and efficient manner and the causes of any inefficiencies or uneconomical practices, including inefficiencies in management information systems, administrative procedures, or organizational structure.

"(3) Program Results - determines whether the desired benefits are being achieved, whether the objectives established by the legislative or other authorizing body are being met, and whether the agency has considered alternatives which might yield desired results at a lower cost." [17:2]

c. Other Types

A review of professional auditing literature reveals a multitude of other terminology which superficially suggests the existence of additional types of auditing. A more in-depth study however, discloses that such terms as "Management Audit," "Operational Audit," "Management Services Audit" and "Activity Audit" are in actuality only extensions,

refinements or combinations of the three types of auditing defined above. For example, the term "Operational Audit" as used most frequently, refers to the review of operating controls and procedures to evaluate the efficiency and to some extent the effectiveness of operations. A definition of "Operational Audit" has been stated as follows:

"The term 'operational audit' refers to appraisals of the administrative controls over activities other than those included in accounting and financial audits. For example, some of the activities regularly covered by operational audits are: purchasing, receiving, shipping, traffic, stores, personnel, office services, production control, engineering, quality control, insurance, advertising, and marketing.

The internal auditor's objectives are based on the needs of management he serves. These needs may be summarized as follows:

Top management needs:

- assurance that its plans (as set forth in statements of objectives, programs, budgets, and policies) are comprehensive, consistent, and understood at the operating levels.
- objective information on how well its plans and policies are being carried out at the operating levels.
- reassurance that all operating reports can be relied on as a basis for action.

Operating management needs:

- information on weaknesses in administrative controls, particularly as to possible sources of waste.
- aid in measuring the efficiency of operations by feedback of information on the quality and cost of the work and adherence to schedule.

In attempting to meet these managerial needs, the internal auditor samples the work performed to see whether it is in accordance with approved procedures. He verifies

the accuracy and consistency of the information contained in the operating reports and he studies the format of these reports to determine whether the information is presented in a meaningful form.

Above all, the internal auditor is alert for indication of sources of waste and opportunities for improvement. The auditor's traditional protective responsibility for seeing that the company's needs are safeguarded against loss, . . . , has now become more broadly interpreted as a constructive responsibility for providing protection against waste of many kinds, and in general to help management operate effectively and profitably." [18:832-833]

As shown by the description of "operational auditing" presented above, the term in actuality encompasses elements of the "economy and efficiency" and "program results" audits defined previously. The other terms mentioned above can also be shown to be special cases or combinations of the three basic types of auditing defined by the GAO.

The three basic types of auditing can perhaps be best understood by studying the basic objectives and purposes of each, which are summarized below.

d. Financial and Compliance

The "financial and compliance" audit focuses on the financial reports of an organization which leave that organization and are used by higher echelons or other interested parties (such as the stockholders of a corporation or the SEC). The financial operations and recordkeeping necessary for the compilation of these reports are scrutinized by the auditor to enable an attestation as to

their fair presentation of the organization's financial position. In conducting this type of audit, the auditor is interested in not only the accuracy of the records but also the consistent compliance of the recordkeeping procedures to applicable laws, regulations, principles and policies. The auditor, in contrast, is not particularly interested in better ways of accomplishing the organization's objectives, unless of course, sufficient waste exists to effectively border on fraud.

The auditor, in a financial and compliance audit, is seeking only to attest to the fair presentation of the organization's financial reports. If transactions are recorded correctly and completely, properly summarized and presented in a clear, consistent manner; the requisites for attestation have been met and the auditor may then express an opinion in that regard.

e. Economy and Efficiency

In an "economy and efficiency" audit, the auditor focuses on the organization's use of resources. While ensuring compliance with applicable laws, principles, etc., the auditor's main thrust is on the relationship of resources to output which is the definition of efficiency. [8] The auditor's objective is to provide management with a determination as to the relative efficiency of operations when compared to some industry standard, in-house objective or mathematically determined optimal level.

The auditor must consider and review all areas which impact on the production of the organization's output. The GAO recognized this when it included management information systems, administrative procedures and organizational structure in its definition of an "economy and efficiency" audit. In short, in this type of audit, the auditor strives to provide management with a status report on the efficiency of its operations and with recommendations for improvement. The goals and objectives of the organization are usually taken as given; and are normally reviewed only as a basis for determining what the resources used should be compared against. The bottom line is an attempt, through careful systematic analysis, to minimize the ratio of resources consumed to outputs produced.

f. Program Results

In the "program results" audit, the auditor must take a strategic (as opposed to operational) viewpoint. The auditor reviews the organization's operations from the standpoint of whether the goals and objectives established by the legislative or authorizing body are being met by the organizations' outputs. By definition, this could be referred to as an "effectiveness" audit. [8] The auditor is less concerned with the routine operations of the organization, and interested mainly with the relationship of

the final output of the organization to the stated goals and objectives. The auditor must determine the outputs and objectives, and through analysis determine if the desired results are being achieved. During the course of this analysis, the auditor must evaluate other alternative means of accomplishing the desired results and even go so far as to evaluate the need for the organization at all. This facet of "program results" auditing has been stated by Anthony and Herzlinger as:

"We are here concerned not with evaluations of specific aspects of a program, but rather with the broad evaluation of a program as a whole, particularly of those programs whose continued existence is optional. If these programs are not effective, they should be discontinued, or at least redirected." [8:521]

Anthony and Herzlinger continue by providing insight into the history and scope of "program results" auditing:

"At the federal level, legislation requiring oversight of programs has been in effect since 1946. The scope of formal evaluation efforts was greatly enlarged in the early 1970's when the federal government delegated to the states the task of providing most social services and required as a condition of funding these programs that a formal means of evaluating them be established. At about the same time, there was widespread interest in 'sunset legislation' - laws that provided for the automatic discontinuance of a program unless it was evaluated every six to eight years and found to be effective (emphasis added). As of 1977, 23 states had enacted some form of sunset law, . . ." [8:521]

3. Summary

In summary, this section has defined auditing and described the three basic types. These types of auditing

have been defined and explained from the viewpoint of the auditor; and their affect on the auditors focus discussed. This section has provided the reader with a basic knowledge of the purpose of auditing and the several ways it can be used by management, or management's superiors, to gain knowledge about the financial condition, efficiency, and effectiveness of operations. The terminology used to describe and differentiate the originating authority and ultimate user of audit information is discussed in the next section under the heading, "Levels of Audit."

C. LEVELS OF AUDIT

1. General

This section will discuss the subject of auditing from the standpoint of organizational position. The viewpoint used will mostly be that of the DON local or field activity commander, commanding officer or officer-in-charge. Parallels will be drawn whenever possible, to the private sector in order to provide the reader with additional insight and understanding.

To properly understand the term "level," one must first comprehend the applicable organizational hierarchy. The local DON commander, commanding officer or officer-in-charge will be loosely equated in this thesis to the head

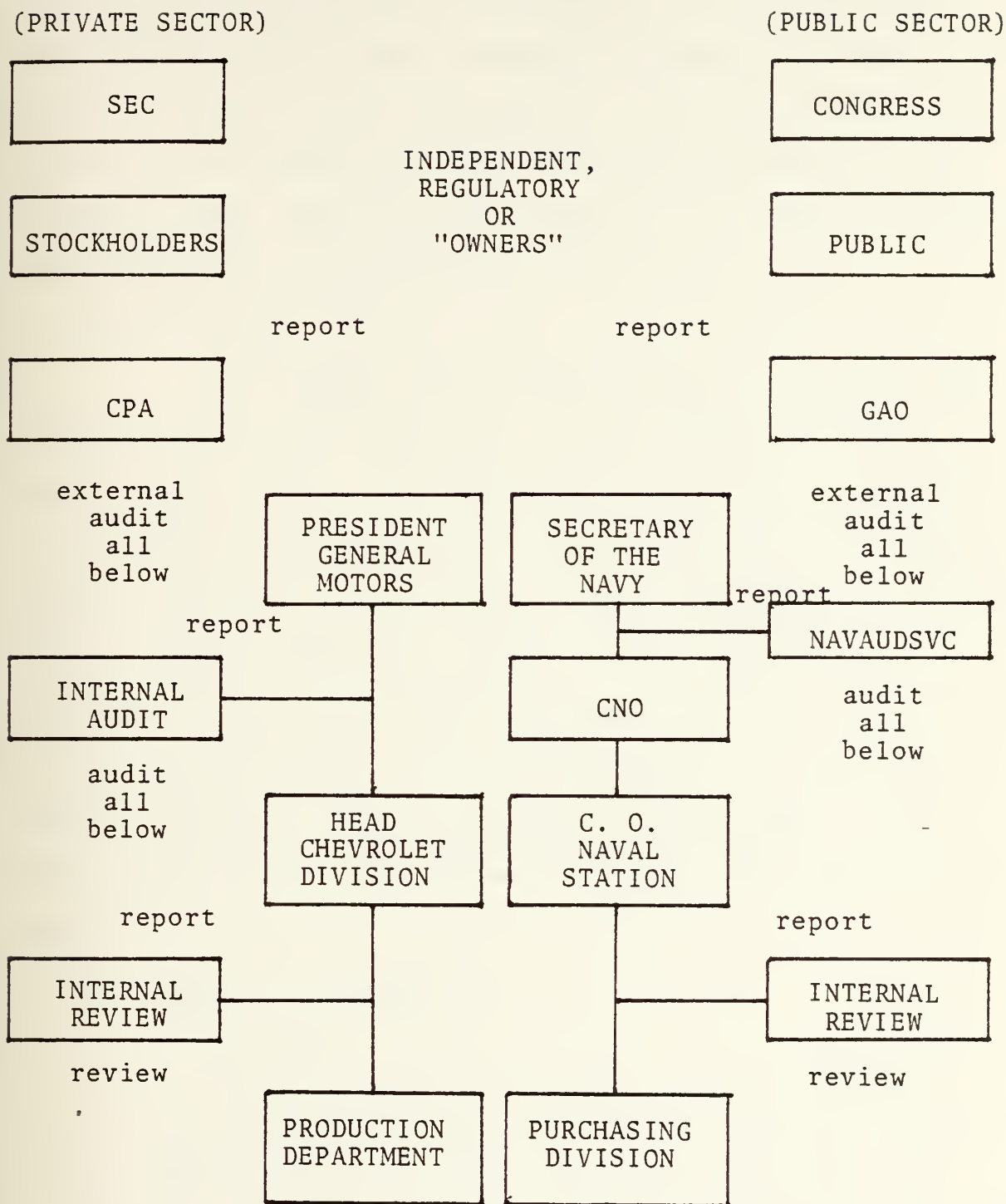
of the Chevrolet division of General Motors (GM). This will provide the reader with a private sector reference point from which to compare and contrast the various organizations mentioned.

As shown in figure II-1, the head of the Chevrolet division reports ultimately to the president of GM. This can be equated, as shown in figure II-1, to the local DON commanding officer reporting through the Chief of Naval Operations (CNO), to the Secretary of the Navy (SECNAV). Each of these "chief executives" is ultimately responsible to the "owners" of the entity. In GM's case, it is the stockholders of the corporation; and in the USN it is the general public, or the taxpayers. Positioned, in a regulatory sense, "between" the "owners" and the "chief executive" are the regulatory oversight entities of Congress and the SEC. While the analogy is not exact, it serves to illustrate the "external" nature of the first level of audit to be discussed.

2. External Auditing

a. Private Sector

In the private sector, an "external" audit is performed on a corporation or division of a corporation by an independent Certified Public Accountant (CPA). This CPA is truly independent of the audited entity; and provides any report generated to someone higher in the organizational



EXTERNAL AUDITING & INTERNAL AUDITING
AND THEIR RELATIONSHIP TO
INTERNAL REVIEW

Figure II-1

hierarchy than the "chief executive." In the case of GM, the auditors' report would normally be addressed to the board of directors and stockholders, with a copy submitted to the SEC as required by the Securities Exchange Act, as amended. Thus, the "external" nature of the audit is upheld from inception to conclusion.

b. DON

In the DON, an "external" audit is perhaps best characterized by the audit of a local command or field activity by the GAO. The GAO auditor is totally independent of the DON; and the GAO audit report is submitted to Congress. Unless the report is classified, it is available free to the general public upon their request. Other examples of "external" audit in the DON, are audits by Department of Defense (DOD) agencies such as the Defense Contract Audit Agency (DCAA) and the Defense Audit Service (DAS). As in the private sector example, the externality of the audit is complete.

3. Internal Auditing

a. General

Organizationally located in a staff position to the "chief executive" is an "internal" audit function. In the USN, this function is performed by NAVAUDSVC under the direction of the Auditor General of the Navy (AUDGEN).

The designation "internal" comes from the organizational location of the function within an organization as opposed to the external CPA or GAO auditor.

The IIA has described internal auditing as:

"An independent appraisal function established within an organization (emphasis added). to examine and evaluate its activities as a service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls." (Duties of the Internal Auditor, 1957)

Lawrence B. Sawyer offers a further definition of internal auditing which addresses the internal auditor's opportunities as well as responsibilities, representing a "top-down" management oriented approach. This definition also has equal applicability to internal review with respect to its opportunities and responsibilities.

"Internal auditing is the independent appraisal of the various operations and systems of control within an organization to determine whether acceptable policies and procedures are followed, established standards are met, resources are used efficiently and economically, planned missions are accomplished effectively, and the organization's objectives are being achieved." [12:26]

Internal auditing may be distinguished from external auditing by its degree of independence, its focus, its location internal to the organization, and its main responsibilities. In the public sector, GAO has clarified these differences as follows:

"Although there are numerous areas of common interest between the General Accounting Office and an agency's internal auditors, certain basic objectives and responsibilities differ. Internal auditing is an integral part of the agency's system of management

control. In its audits, the General Accounting Office is concerned with the entire control mechanism within an agency, including the various arrangements made by the management for internal audits and other forms of inspection, appraisal and evaluation. If warranted by its evaluations, the General Accounting Office will rely on such work and make full use of it in conducting its examinations." [19:264]

b. Authority

The authority for internal auditing in the DON is provided by the National Security Act Amendments of 1949 and The Budget and Accounting Procedures Act of 1950, also known as the Accounting and Auditing Act of 1950. The first required the Secretary of the Navy to organize and conduct internal audit in a manner consistent with the operations of the Office of the Comptroller of the DOD. [20:19] The second required each Government agency to establish and maintain systems of internal control, including internal audit. [14:1]

c. Purpose

The purpose of internal auditing in the DON has been stated by SECNAV as:

"Internal audit in the Department of the Navy, under the responsibility of the NAVAUDSVC, is the independent evaluation of programs, activities, systems, procedures, and other operations involving the expenditure of funds, utilization of resources, or accomplishment of management objectives. The purpose of audit is to provide service to management at all levels through the objective performance of independent evaluations to determine the adequacy and effectiveness of practices, procedures, and controls. This is accomplished through objectively reporting results of audits, making constructive recommendations, and providing consultation while management plans action to be taken on findings and recommendations." [21:1-4]

d. Organization

The internal audit function in the DON is under the direction of the AUDGEN who serves as the staff assistant for audit matters to the Under Secretary of the Navy (UNSECNAV). The AUDGEN also receives technical guidance and supervision from the Assistant Secretary of the Navy (Financial Management) (ASN(FM)). [21:1-4]

The NAVAUDSVC is comprised of a Headquarters activity and four regional offices. Each regional office is assigned a geographic area, and is responsible to the Director, NAVAUDSVC for the planning, supervision, conduct and review of all internal audits in their area. [21:1-4]

e. Concentration

The main focus of audit attention by the NAVAUDSVC is on those functions which are of primary concern to management from the local commander through the SECNAV. [21:1-5] It is SECNAV policy that the primary concentration of audit effort will be on the functions most directly involved in accomplishing the activity's mission; and the extent to which other functions are examined depends on their support of mission performance or specific interest indicated by the activity or higher authority. [21:1-5] Other functions which are usually audited on a routine basis are disbursing, commissary stores, and Morale, Welfare and Recreation (MWR) fund activities. [21:1-5]

Although the stated purpose of internal auditing in the DON is "to provide service to management at all levels," [21:1-4] it should be noted that, except for certain "Management Consulting Services," [21:1-8] the audit report generated by a NAVAUDSVC audit is distributed outside of the local activity, and can be provided to GAO. [21:5-8]

4. Internal Review

a. General

As stated previously, internal review is differentiated from internal auditing not so much by its substance as by the perspective from which it is viewed. Internal review is normally associated with an in-house capability at the lower echelon or activity level. [11:118]

In its formal implementation of the internal review function in the DON, SECNAVINST 7510.8 dated 15 October 1975 entitled: "Internal Review in the Department of the Navy" defined internal review as follows:

"The conducting of special audits, analysis and investigations of financial operations and the use of command resources to detect deficiencies, improprieties and inefficiencies, and to provide recommendations in order to correct conditions that adversely impact on financial management, mission accomplishment, or the integrity of the command."

The above definition is an extension of the previously assigned functions of internal review, which were specified in the Navy Comptroller Manual Volume I as:

1. special studies, analyses and investigations of comptroller areas;
2. audits of nonappropriated funds;
3. assisting in correcting deficiencies revealed by internal audit;
4. participating in the installation of financial and accounting systems;
5. developing financial programs, procedures and controls;
6. advising on organization and staffing in comptroller areas;
7. maintaining liaison with the Naval Audit Service;
8. annual reviews of civilian timekeeping and payroll function.

Thus, although encompassing as wide a scope and jurisdiction as internal auditing, internal review refers to an audit/review function strictly within the organizational structure and management framework of a specific suborganizational entity or activity such as the production department of a corporation, or a Naval Station.

The Comptroller of the Navy has further clarified the distinction between internal review and internal auditing; and provided the key to internal review's value by stating:

"internal review is a function performed within a command, at the direction of the head of that command or in pursuance of a plan approved by him, the results of which are reported to him." [22:2-2]

b. Authority

The authority for internal review in the DON is derived from DOD Instruction (DODINST) 7600.2 dated 7 August 1978 entitled: "Audit Policies," and DODINST 7600.3 dated 4 January 1974 entitled: "Internal Audit in the Department of Defense."

A good overview of this authority is provided by The Task Force on Evaluation of Audit, Inspection and Investigative Components of the Department of Defense report dated May 1, 1980 which states:

"Department of Defense regulations provide that 'within the Military Departments . . . (all internal auditing) will be carried out by a single audit organization' (Department of Defense Directive 7600.2), and that internal review does 'not constitute internal audit as prescribed herein . . .' (Department of Defense instruction 7600.3). Instead, internal review is relegated to a far more limited role:

'Management of lower echelons is not precluded from establishing groups which, while not performing independent or comprehensive audits, would serve as 'trouble shooters' who may make special analysis in comptroller and other areas and assist in correcting deficiencies which are revealed by audits, reports, analyses, observations or other means. In authorizing such internal review activities at any echelon, care should be exercised to assure avoidance of duplication of internal audit functions as defined below which are assigned to the centralized audit organization.'

Aside from the limited provisions of Department of Defense Directive 7600.2 and Department of Defense Instruction 7600.3, which have been quoted above, there is no Department of Defense-level regulatory guidance outlining the role or latitude of internal review, despite periodic requests for clarification of the Department's policy." [11:124]

c. Purpose

The purpose of internal review in the DON has been stated by the SECNAV as follows:

"The Internal Review function is designed to provide Commanders, Commanding Officers, and Comptrollers with an independent in-house capability for review of financial and other resources, related analysis and trouble shooting, and the discharge of assigned audit responsibilities . . . The objective of the Internal Review function is to aid the Commander, Commanding Officer or Comptroller in their role as funds administrators by assessing the fidelity with which prescribed procedures are being followed for the accounting and expenditure of appropriated and non-appropriated funds. Thus, priority attention should be given to those areas where operating conditions of financial complexity may be a factor in overexpenditure or inefficiency in operations; or in obscuring misapplications of funds, fraud or theft." [10:1-2]

d. Organization

The organizational location of internal has been defined by SECNAV as follows:

". . . the Internal Review function should be organizationally placed in a staff capacity to the Comptroller or such other official who may be assigned responsibility for administration of funds. However, should circumstances so warrant, the organizational placement of the Internal Review function should not preclude direct liaison with the Commander or Commanding Officer." [10:1]

e. Concentration

Aside from the caution that, "care should be exercised to assure avoidance of duplication of internal audit functions . . . which are assigned to the centralized audit organizations" which is contained in DODINST 7600.3

referenced above, the areas open to internal review are basically not restricted according to the SECNAV definition of internal review cited previously.

Enclosure (1) to SECNAVINST 7510.8, referenced earlier as the formal implementing instruction in the USN, defines internal review and provides the following amplifying list of functional elements:

". . . Internal Review is responsible for examining internal management controls, practices and procedures at all levels to determine adequacy in concept and effectiveness in application. Further, it insures that there is provision for financial integrity and effective utilization of all available command resources. In addition and where applicable, the Internal Review function includes:

- a. Auditing of the civilian timekeeping and payroll function (NAVCOMPT Instruction 7540.4A), and certain nonappropriated fund activities (NAVCOMPT instruction 7540.5A).
- b. Monitoring the correction of deficiencies which are revealed by the Naval Audit Service, GAO or by other external reports, analyses or observations.
- c. Monitoring and critiquing the design and installation of financial and accounting systems and procedures, with emphasis upon the identification and use of valid audit trails and other management controls.
- d. Providing advice and reviewing the use of quality control and other indicators that routinely gauge the effectiveness of financial management and utilization of command resources.
- e. Designing and applying check lists for internal review of areas that are considered unique or critical to local command in the safeguarding of resources; for example, the areas of (1) physical security, (2) ADP security, or (3) to present/detect theft or fraud involving government resources.

f. Reviewing safeguards or refinements to existing controls for material and financial accountability.

g. At random occasions, reviewing the proper execution of various directed programs such as (1) cost reduction, (2) financial reports generated by or for the activity, and (3) physical inventory and reconciliation.

h. Participating in, from time to time, reviews of other problem areas, as directed.

i. Rendering advice on matters of organization and staffing within Comptroller areas.

j. Maintaining liaison with and providing assistance to auditors of the Naval Audit Service assigned to perform continuous, periodic or integrated audits; providing similar liaison and assistance where appropriate to other audit or inspector representatives such as the General Accounting Office, Inspector General, Command Inspections, etc." [10]

In short, the internal review function is a powerful management control device available for use at the discretion of the local commander or commanding officer. Internal review also serves in an advisory capacity to line management as required.

f. Summary

This section has defined internal review, stated its purpose in the DON and described its decentralized organization. The section has also distilled the authority for internal review in the DON: and shown, through references, the lack of guidance concerning the role and latitude of internal review. Also provided, was an overview of the function internal review has been assigned in the DON.

Prior to describing the benefits to be gained from internal review, it is advantageous to repeat the NAVCOMPT description of internal review which provides the key to internal review's value to the local commander or commanding officer:

"Internal review is a function performed within a command, at the direction of the head of that command or in pursuance of a plan approved by him, the results of which are reported to him." (emphasis added) [22:2-2]

D. BENEFITS OF INTERNAL REVIEW

1. General

The benefits to be gained from effective internal review have been summarized by The Task Force on Evaluation of Audit, Inspection and Investigative Components of the Department of Defense report dated 1 May 1980 as follows:

"Internal review is an especially valuable management tool in that it combines the responsiveness, ready availability and independence of inspectors general - with the special analytical skills of internal auditors. Thus, it provides an internal control mechanism that the commander cannot duplicate with any of his other staff resources. Internal review is also invaluable to the local commander because it focuses solely upon the command's problems, leaving broader, . . . (Department-wide) matters to the internal auditors and senior echelon inspectors general. Finally, internal review enables the commander to call for audit assistance without simultaneously announcing his problems to the world." [11:152]

2. Characteristics of Internal Review

From the above summarization and the professional literature which produced the list of benefits presented in Chapter I, it is possible to distill a list of the salient

characteristics of internal review. These characteristics combine to yield benefits and also to serve as the key to acceptance and effective use of internal review by line management.

The characteristics will be listed and briefly described below in order to provide the reader with the proper semantics for future reference in this thesis. The descriptions are distilled from numerous professional articles and reports, and from textbooks on the subjects of accounting and auditing. Two particularly valuable references for the peculiar "organizational processes" and "Bureaucratic politics" viewpoint of internal review were The Task Force on Evaluation of Audit Inspection and Investigative Components of the Department of Defense Report [11], and the NAVAUDSVC review of the DON's internal review program. [9]

a. Responsive

In this thesis, the term responsive refers to both the willingness and capacity to accommodate the desires and needs of the local commander. It does not refer to the ability, technical or otherwise, to perform the requirements of a task. It does however, refer to the intangible elements of motivation and organizational orientation, and to the tangible limitations of available personnel manhours able to be devoted to any particular assignment.

b. Readily Available

This term refers to the accessibility of the function to the local commander. It refers to the ease with which the local commander can communicate with the personnel performing the function and vice versa.

c. Independent

Independent, in this context, refers not only to the usual interpretation of the term as "being free from control of others," [23:584] but also to the appearance of being free. It also refers to the relationship of organizations, and to the source of authority and reporting responsibilities. This last nuance is linked to the characteristic of obtaining "assistance without advertising problems" discussed below; and together, they may be a strong influence on the local commander.

d. Analytically Skilled

This term refers to the usual training and experience auditors in general receive in analytical techniques such as ratio and trend analysis, applied statistics, regression analysis, etc.

e. Unduplicatible Internal Control Mechanism

This term refers to the use of internal review as a management control and its definition as internal control (see previous definitions). The

adjective "unduplicatible" refers to the necessity for the function to be performed in its entirety and possess all of the characteristics listed herein for it to be effective.

Concerning this facet of internal review, The Task Force on Evaluation of Audit, Inspection and Investigative Components of the Department of Defense stated:

"Thus, the vast majority of duties currently undertaken by internal review personnel could not be performed by a centralized internal audit organization and, (if consolidated), the local commander would be forced to devote other staff resources to the internal review effort." [11:140]

This supports the view that the function performed by internal review cannot be performed in its entirety, or even in its majority, by centralized audit organizations; and, if consolidated, other additional resources would be required to "duplicate" the function.

f. Sole Focus On Local Command's Problems

This characteristic refers to the undilution of the focus and attention of a local command's internal review function. The function is local in viewpoint and responsible only for areas unique to the local command, or only for segments of a broader area which directly affect the local command. It also refers to the increased likelihood that an inquiry will "focus on the local commander's precise concerns rather than the auditor's own judgement's regarding the wisdom, scope, location, timing and purpose of the audit." [11:149]

g. Assistance Without Advertising Problems

This characteristic is mostly self-explanatory, but one should not interpret the implicit meaning in the context of a "cover-up." Rather, one should construe this characteristic as providing the local commander the ability to identify and correct problem areas without being subjected to additional scrutiny and criticism as a consequence of those efforts. [11:151]

h. Flexible

This term refers to the ability of a local function to shift emphasis or reorder plans as the results of new developments. In this manner, it is related to the characteristic of responsiveness described above. An additional connotation, is the ability of the internal review function to conduct audits or reviews of areas that are not financial in nature, such as mission operations.

i. Streamlines Other Audit Effort

This characteristic refers to the ability of internal and external auditors to "build on" the work of the internal review function, rather than duplicating the work. In general, this would help to reduce the amount of time required to perform internal or external audits; thus reducing the interpretations to local commands. Of course, the internal or external auditors would have to be satisfied as to the extent and reliability of internal review prior to accepting it.

j. Provides For Corporate Knowledge

This characteristic refers to the construction, over time, of a repository of information, experience and knowledge concerning the local command's unique history, operations and problems. This ability stems from serving as the command's focal point for liaison with outside inspectors and auditors; and also from the fact that approximately 98 percent of the full-time internal review personnel in the DON are civilian personnel. [9:2] Since civilian personnel tend to remain in one location longer than their military counterparts, their penchant for assimilating and retaining data unique to the local command is greater. This fact, coupled with the wide range of internal review activities and interests, combine to provide the local commander with an information storehouse of obvious management value.

k. Solution Oriented

This characteristic refers to the perception and recurring criticism of outside auditors by commanders and commanding officers that:

" . . . many (internal) auditors seemed to dwell on finding and reporting deficiencies rather than determining solutions, and seldom made positive comments on portions of operations found to be satisfactory . . . Managers often believed they had a better method to correct the deficiency than was recommended by the auditors, but felt that the auditors did not adequately consider management's solution." [11:149-150]

Since the internal review function works for the commander, the inquiry is more likely to focus on his or her precise concerns and, of necessity, dwell on solutions to the problems in order to recommend same to the commander. [11:149]

3. Benefits of Internal Review

The benefits to be derived from the effective application of internal review are a function of the characteristics described in the previous section. In order to properly understand the internal review function and also why the similar characteristics of internal auditing do not produce the same benefits, the reader should possess some knowledge of bureaucracy. The reader should also understand two models of decision making described by Graham T. Allison as the "Organizational Process Model" and the "Bureaucratic Politics Model." [24:274]

Robert P. Haffa, Jr. has summarized these two models in his article "Allison's Models: An Analytic Approach to Bureaucratic Politics" as follows:

"The key to understanding . . . (Allison's Models) . . . is contained in Allison's thesis. He states that explanations, predictions, and evaluations of policy decisions are significantly influenced by the Viewpoint of the analyst. [25:224]

. . . This model (Organizational Process) assumes that policy decisions can be better understood as outputs of large organizations rather than as rationale choices of single actors. The federal

government is more like a mosaic than a monolith; it is 'conglomerate of semi-feudal, loosely allied organizations, each with its own interst.' But these organizations, as the nation itself, are not of a single mind. Thus the United States Air Force is a component organization of the national government, but it is 'an agglomeration of commands, forces, and staffs, each with its own institutional interests and goals, its own identity and memory.' [25:225]

. . . According to Allison's third model (Bureaucratic Politics), governmental decisions can be analyzed as outcomes of bargaining games. This model does not visualize a unitary actor, neither in the form of a nation-state nor in the organizations that compose the government. Model III concentrates instead on the human actors, the players that are engaged in a contest of influence and compromise. Thus decision making becomes a bargaining process, and policy emerges as a political outcome (emphasis added).

The essence of the Bureaucratic Politics Model is its emphasis on people.

. . . An analyst utilizing Model III . . . would concentrate on the political struggles and bureaucratic maneuvering . . . the politics of discovering, the politics of issues and the politics of choice." [25:225]

The purpose of the above discussion was to emphasize the parochial significance of the organizational location or position of the internal review function. The mission of internal review:

". . . to augment the commander's (emphasis added) ability to detect problem areas and to respond immediately to warning indicators within a command (emphasis added) by performing evaluation of command programs, procedures and operations, especially those related to expenditures of funds, use of resources and the control of command property, material and supplies." [11:118]

is thus materially affected by the organizational position or location of the function itself. The location of the function has direct bearing, as shown by Allison, et. al., on the viewpoints and attitudes of not only the purveyors of the service (the auditors) but also the recipients and users of the service (the local commanders).

This difference in viewpoints and attitudes is perhaps best illustrated by several findings of The Task Force on Evaluation of Audit, Inspection and Investigative Components of the Department of Defense which state in part [11:145]:

"We disagree with the . . . proposal to merge . . . (internal review and internal audit) because commanders are becoming increasingly reluctant to solicit audit assistance from their respective internal audit agencies. In this respect, we are in agreement with an earlier study which:

'found that the commanders at Air Force bases visited generally considered the resident Air Force Audit Agency auditors as external (emphasis added) and preferred to provide for . . . (internal review) in-house. Hence, request audits at the base level (USAF's equivalent of USN internal review) were relatively infrequent.' (Joint Department of Defense Study, Report of Survey of Utilization of Internal Review Personnel in the Department of Defense and Relationship to Internal Audit Function, August 16, 1967)

. . . the Air Force Audit Agency's 'policy is to be responsive to commanders' problems, but (to) be selective in evaluating CAP (Commander's Audit Program) requests. (Air Force Audit Agency Regulation 175-110, Ch. 65-2 (h), October 31, 1979)

. . . In this respect, . . . several of the Air Force auditors interviewed . . . stressed their selectivity in undertaking command request audits and indicated that they declined to provide requested

audit assistance whenever the problem area identified by the (local) commander did not 'merit' audit attention.

The above findings and statements show that, from the viewpoint of the local commander, an internal audit agency is regarded as being external; and thus available services are only reluctantly requested. Also, the attitude of the internal audit agency tends to remain that of a separate entity with broader objectives, even when requested to perform internal review functions as a portion of assigned responsibilities.

This section has thus far presented the reader with data from which to develop an understanding of the tacit importance of the location or organizational position of the internal review function. As demonstrated by The Task Force on Evaluation of Audit, Inspection and Investigative Components of the Department of Defense, locating the internal review function outside of the local command tends to produce the situation where internal review services are reluctantly requested and reluctantly provided. [11:145]

The reader should bear this tendency in mind, as well as the dictums of the organization process and bureaucratic politics models of decision making presented earlier, when contemplating the benefits of internal review retendered below.

a. Internal review is a strong flexible management control tool of basically unlimited local scope, the use of which is at the discretion of the local commander. As shown by the previous discussion, the flexibility and discretionary nature of internal review is dependent in part, upon the organizational position of the function itself. In order to provide management control, as defined by Anthony, et. al. [8:3], the function by definition, must be under the direction of the local commander in his or her role as funds administrator or resources manager." [10:2]

b. Internal review is responsible directly to line management, not to outside agencies. Herein lies perhaps the most important facet of internal review. It is a benefit in the sense it provides the local commander with an investigative, problem-solving tool; and a characteristic in the sense of providing the local commander with such a tool without opening the command, and thus the commander personally, up to additional scrutiny and criticism. [11:149-151] In order to completely comprehend the significance of this trait, one must consider the environment in which the local commander operates and also the implications of the bureaucratic politics model of decision making. The environment has been characterized not only by the quotations presented in Chapter I of this thesis but also by The Task Force on Evaluation of Audit, Inspection and Investigative Components of the Department of Defense as follows:

"Throughout the military departments, and to an extent not found in civil agencies, decision-making authority and corresponding accountability for failure (emphasis added) is assigned to commanders at every level. This accountability is magnified by the fact that the individual commander's responsibilities go well beyond those directly associated with the state of training, discipline and operational readiness of the unit's personnel and equipment.

The commanders of bases, installations, industrial activities and separate commands are solely responsible (emphasis added) for all (emphasis added) of the support facilities required to operate and sustain their command.

. . . To meet the foregoing responsibilities commanders need local and immediately available audit assistance . . ." [11:119-121]

The fact that the environment of accountability is real and on a personal level to the local commander, forces the local commander to conform to the bureaucratic politics model of decision making. This particular aspect of the model has been characterised by McNallen, Zand and Lewin as follows:

"In the Political Process or Bargaining Model, the primary value or objective is the achievement of power, influence and personal goals (promotion, wealth, publicity, fame, honors, etc.) of the leaders or managers." [26:45]

Thus, because of the personal and accountable nature of the environment, the responsibility of internal review to local line management and not to outside agencies is of real importance.

c. Internal review allows the commanding officer to concentrate effort and expertise on areas within his or her cognizance which are suspect of, or susceptible to inefficiency, ineffectiveness, fraud, over-expenditure, questions of fact; or areas too financially complex to permit a rapid assessment by the commanding officer as a layman. In its capacity as an independent internal advisory staff function, internal review can be directed by the local commander to focus on the areas listed above in a manner not possible by operational components of the command. [11:118]

d. If well done, the work of an internal review function will not be duplicated (but will be built upon) by outside agencies, specifically the GAO or the NAVAUDSVC. The Task Force on Evaluation of Audit, Inspection and Investigative Components of the Department of Defense opined that:

". . . the command's internal review effort would contribute to the overall audit service . . . Defense directives already anticipate that internal auditors will themselves build upon rather than duplicate the work of internal review . . . the General Accounting Office standards state:

'Many governmental entities have internal review activities identified by other names, such as inspection, appraisal, investigation, organization and methods, and management analysis. These activities are often in the nature of management services, and in varied ways they assist management in currently supervising, advising, and reviewing designated functions. To prevent duplication of effort, all auditors - regardless of their level of government - should use, to the maximum practical extent, the work that other auditors or internal review personnel have previously performed.' (GAO Standards for Audit, p. 34)

Thus, internal review would continue to be a supplement to, rather than a substitute for, internal audit." [11:154-155]

e. Independent internal review affords harried line management an excellent opportunity to "get out of the trees and look at the forest." This benefit accrues from the characteristics of internal review previously discussed and refers to the need of all operational managers to maintain the colloquial "Big Picture."

f. Internal review serves as an expert flexible advisory staff to the commanding officer. This benefit is especially descriptive of the USN's internal review function, which makes extensive use of personnel on an ad hoc basis. [11:130] This allows the local commander to assign functional "experts" from other areas of the command to assist the internal reviewers in the conduct of special analyses, etc. requiring special training or experience not found in the internal review cadre.

g. Internal review has the propensity to identify legitimate dollar savings which line management can apply to other areas. The Task Force on Evaluation of Audit Inspection and Investigative Components of the Department of Defense has summarized this relationship as follows:

". . . attention to the more traditional concerns for adequate financial audit coverage of assets, liabilities, income and expenses, . . . should not be relegated to a position of secondary importance. The vulnerabilities to fraud, waste

and abuse addressed by financial and compliance audits, . . . are of constant and pressing concern to installation commanders . . . (and) address areas in which the commander and his other staff advisors are the least equipped to protect themselves without professional audit assistance. . .

Given the internal auditor's primary emphasis on economy and efficiency audits of major, service-wide programs and systems, it is all the more important that the local commander retain . . . (capacity of) internal review."
[11:144, 145]

h. "Internal review augments the commander's ability to respond immediately to warning indicators within the command by performing evaluations of command programs, procedures and operations; especially those related to the expenditures of funds, use of resources and the control of command property, material and supplies." [11:118]

i. Internal review can serve as the commander's focal point, clearinghouse and follow-up reviewer for previous audits by external sources (GAO and NAVAUDSVC) or previous internal reviews; and as liaison with external audit agencies. This not only serves to organize the command's responses to various external audits but also provides the framework for the development of a corporate memory which was discussed previously.

In summary, and to repeat a previous observation, if properly organized, staffed and executed, internal review could provide invaluable aid to line management in many areas; and serve as an extension or alter ego of the commanding officer.

E. REQUIREMENTS OF INTERNAL REVIEW

This section will provide the reader with an overview of the requirements for effective internal review. Many of the requirements, while important, are self-evident

and will receive little discussion. Also of note, is that the uniqueness of individual commands precludes absolute statements as to the specific amount necessary of each requirement. Accordingly, words such as "sufficient" or "enough" must be used when descriptions are provided. As such, the list developed will be general in nature and provide only a framework for the development of specific requirements for any given organization. It is the objective of the description, when given, to provide the reader with the level sufficiency required, in order to provide a goal for the determination of "how much is enough."

1. Organization

a. Internal review should have complete independence in order to make recommendations free of pressures from other management personnel. (SECNAVINST 7510.8)

b. Internal review should have its own budget. [27:94] This helps insure independence and lessens the tendency to divert internal review resources to other areas.

c. Internal review should have direct access to the commanding officer if the circumstances warrant. (SECNAVINST 7510.8)

d. Internal review personnel should be free from assignment to operational roles. [11:161] For example, the use of internal review personnel as additional accounting resources. "The special value of internal review derives from its independence from operational responsibility and its ability to provide the commander with objective analyses and reports." [11:161]

2. Staffing

a. Sufficient numbers of personnel should be assigned to accomplish the intent of internal review. (SECNAVINST 7510.8) The intent of internal review has been outlined previously, and shown to be the prerogative of the local commander. Accordingly, the local commander should assign sufficient numbers of personnel to accomplish the duties assigned.

b. Personnel assigned should have the necessary technical qualifications. (SECNAVINST 7510.8) SECNAVINST 7510.8 states: "Typically, the disciplines represented in an internal review staff would consist of (1) financial management and (2) the dominant technical, scientific or management skill represented by the command mission." [10:Encl (2)]

c. Adequate training should be provided on a continuing basis. (SECNAVINST 7510.8) SECNAVINST 7510.8 states: "training should include not only auditing fundamentals and techniques of critical review and examination, but also new areas of management interest such as use of ADP applications . . . " [10:Encl (2)] Examples of some of the available training are:

1. Army Audit Agency:

One-week and two-week courses covering financial management, military accounting, statistical sampling and operational auditing. [11:135]

2. Auditor General of the USN:

A basic-level forty-hour course entitled "Introduction to Navy Audit and Internal Review." [11:136]

3. Naval Postgraduate School:

Two-week course in practical comptrollership.

d. Adequate supervision and guidance should be provided. (SECNAVINST 7510.8) Felix Pomeranz has provided the following criteria to assist in the determination of adequacy of supervision [27:95-100]: Internal review should have written goals and objectives, a policy and procedures manual, written audit programs, standards of field work and job

descriptions. In addition, the working papers and performance of internal review should be periodically evaluated.

3. Work Performance

In listing the requirements of good work performance, the thesis draws heavily from NAVAUDSVC Audit Program No. 32 - Internal Review in the Department of the Navy (January, 1979). Accordingly, unless otherwise referenced, all statements and quotations are taken from that source.

a. Internal review should have an established audit plan that "ensures scheduling of those areas of mandatory and traditional audit coverage and allows for operational studies and reviews especially in those areas that may lend themselves to fraud or abuse."

b. Internal review should use NAVAUDSVC standardized audit programs in the conduct of its review of functional areas.

c. Internal review, as a minimum, should have audit coverage of the following functional areas:

1. Civilian Payroll and Timekeeping - Audit Program No. 2.

2. Accountability and Control of Plant Property and other Navy Property - Audit Program No. 6.

3. Procurement and Supply Management - Audit Program Nos. 8, 10A, 10B, and 12.

4. Management of Transportation Equipment - Audit Program No. 27.

5. Non-appropriated fund activities - Audit Program No. 33.

d. Working papers should properly document the reviews conducted. (GAO Standards and SECNAVINST 7510.8).

e. Internal review should conduct liaison and follow-up action. (SECNAVINST 7510.8)

4. Command Support

The requirement of "command support" is nebulous, but important to effective internal review. Proper or sufficient command support is indicated by such things as the existence of command instructions regarding internal review, evidence of action by the commanding officer on the findings and recommendations of internal review and evidence that command attention is focused on providing both the appropriate quantity and quality of internal review personnel. [28:4]

Perhaps the greatest impact of command attention is in the area of "motivation." The following excerpt from the NAVAUDSVC Audit Emphasis Program on Internal Review in the Navy supports this view:

"Our discussions with Internal Review personnel, review of their reports, and observations indicated a lack of motivation and assertiveness within the division . . . We believe that one of the primary problems in Internal Review is that the auditors feel that management is not responsive to their recommendations, therefore, 'why bother' . . . with a lack of motivation permeating Internal Review, the new people (recently hired) could develop similar motivational attitudes." [10:D-3]

F. SUMMARY

This chapter traced the history of auditing, differentiated between the various types and levels of auditing, and stated the characteristics and benefits of effective internal review. The requirements necessary for effective internal review were overviewed as well.

The numerous definitions, references and quotations used in the chapter were not intended to add length or clutter, but to provide the reader with documented evidence upon which to gain perspective on the background material presented. In such a study as this, the absence of quantitative data forces narrative descriptions and arguments vice definitive graphic displays.

The chapter sought to convey a sense of history and development of auditing in general and internal review in particular. In addition, the chapter's objective was to imbue the reader with a perspective of internal review from the local commanding officer's viewpoint with which to assimilate the characteristics, benefits and requirements listed.

The next chapter will provide the reader with the current status of internal review in the DOD, concentrating on the U.S. Marine Corps and U.S. Navy.

III. STATUS OF INTERNAL REVIEW

A. INTRODUCTION

The purpose of this chapter is to present the reader with evidential matter from which to judge the current position of internal review in the Department of the Navy (DON) in as objective a manner as possible.

This chapter will provide the reader with documented survey results which indicate the status of internal review in the DON. To a lesser degree, internal review in the DON will be compared and contrasted with its counterparts in the Department of the Army (DA) and the Department of the Air Force (DAF).

As a possible aid to enable the reader to gain a better understanding of the subjective points of the discussion, the reader might want to visualize an "internal review balance sheet" in which the various aspects of internal review discussed can appear as asset or liability "accounts." These "accounts," much like those known in the private sector accounting vernacular as "differred costs/charges" or "differred revenues/credits," [29:13] are able to assume either "asset" or "liability" classifications depending upon the account's balance. Examples of these types of private sector items are: prepaid insurance, prepaid rent, income taxes payable or prepaid taxes.

[29:13, 14]

A specific example would be the situation where a business entity leases its facilities. In the case where the lease payments are "prepaid" (i.e. paid on the first day of the period for the entitlement to use the facilities throughout the period), a balance sheet "snapshot" on a specific date during that period, would probably show the account balance as "positive," or an "asset." On the other hand, in the case where lease payments are paid at the end of a period to cover the use of the facilities during that period a balance sheet "snapshot" would properly reflect some allocated amount as a "negative" or "liability account" representing the entity's obligation to pay for its use of the facilities to date.

While the analogy is not direct or as clear as the above example, the various aspects of internal review behave in much the same manner. Consider, for illustration, the general category of "staffing." Since all commands and field activities are to some degree unique, there can be no single measure of sufficient staffing. However, there can be a subjective determination of sufficiency. If the determination is that sufficient staffing exists, the "account" termed "staffing" would be an asset and have a positive affect on the "internal review balance sheet." However, if it is determined that staffing is insufficient, then the staffing "account" would be considered a liability and have a negative affect on the "balance sheet."

Like the financial statement, the "internal review balance sheet" has a balancing account. Instead of "retained earnings," this author offers that the internal review balancing account might be designated "effectiveness;" and be visualized to carry a "positive" balance - indicating effectiveness, or a "negative" balance - indicating ineffectiveness. The magnitude of this balance would indicate the use of what adjectives such as "more" or "less," should be applied when referring to the interpretation of the "account."

Throughout the following discussions then, the reader should maintain a mental register of the various "account" balances, which culminate in a subjective determination of the "effectiveness" of internal review in the DON.

B. GENERAL

"There are many important issues we all must contend with each day, and I realize that the time available to fully explore each of these is rather limited. Among these issues, however, I consider three to be of particular significance to our financial management community - violation reports, overtime practices, and internal review (emphasis added).

. . . with the establishment of an effective internal review program, great strides can be made in eliminating waste, fraud, and abuse in Government expenditures. Unfortunately, many activities have not implemented an internal review program, and many of those that have, have limited the scope of their internal review functions to areas not directly related to mission accomplishment. (emphasis added) In an era when funds and ceiling points are constantly being cut, a good internal review staff will more than pay for itself.

These are matters of considerable importance to me and to you and I feel they merit Command attention. I would appreciate your conveying to your Commanding Officer or Officer in Charge my thoughts on these issues." [30:2]

With these words, the acting Comptroller of the Navy (NAVCOMPT), RADM S. D. Frost, SC, USN, has summarized both the importance and status of internal review in the DON. Not only that, he has directed in strong diplomatic language that internal review "become" important to the DON's financial managers' and levied upon these comptrollers and fiscal officers the duty of educating line management accordingly.

What prompted one of the DON's highest financial managers to make these statements? What evidence exists to support the conclusion that ". . . many activities have not implemented an internal review program, and many of those that have, have limited the scope (of internal review) . . . ?"

This chapter will seek to answer these questions by providing the data upon which this author feels the conclusion quoted above was based. In doing so, the chapter will concentrate on four major areas of measurement - existence, staffing, organization and performance. Like NAVCOMPT, the author will rely heavily upon the work of the NAVAUDSVC [9] whose conclusion NAVCOMPT restated above. Also, recent surveys by The Task Force on Evaluation of

Audit, Inspection and Investigative Components of the Department of Defense (hereafter referred to as the "Task Force") [11] and by Lieutenant Colonel John C. Baggette, USMC [20] will contribute substantially.

The "Task Force" states that "several evaluations of internal review activities, . . . have challenged the overall quality of internal review work performed within Defense (Department of)." [11:134] The report continues with the following excerpts from the Draft Study of the Operations and Relationships of Audit, Inspection and Review Groups in the Department of Defense. [11:134, 135]

"The work of most internal review activities was very limited in scope and depth, and the quality of work was generally unsatisfactory in 72 percent of the reports and workpapers we reviewed."

"In the Army . . . only 41 percent of the work done by these activities met the minimal standards for audit. Audit programs normally were not prepared . . . and data collected . . . was often not sufficient to support the findings contained in reports."

"Only three of the seventeen Navy internal review offices we visited were doing any work which met audit standards."

"We reviewed five reports and workpapers (undertaken by Marine Corps internal review personnel) and found that minimal audit standards had been met in one."

The above summarization emphasized shortcomings relating to the measurement areas of organization and work performance; namely: "limited in scope and depth" and "generally unsatisfactory." It is interesting for purposes of this

thesis, to note that while the characterization holds true for all the military Departments that were reviewed, the DON (USN and USMC) appears to be the worst (17.6 percent and 20 percent respectively, compared to 41 percent for DA).

Prior to concentration on the DON, it would be beneficial to understand the internal review functions of DA and DAF. Accordingly, the next two sections will outline for the reader the organization and status of the internal review functions of the DA and DAF in order to provide a basis for comparison and contrast.

C. INTERNAL REVIEW IN THE DEPARTMENT OF THE ARMY (DA)

1. History

The DA internal review function was established shortly after the passage of the National Security Act Amendments of 1949 for the purpose of enabling commanders to "examine subordinate activities with identified or possible problems and to decide upon remedial measures."

[31:2]

Initially, the internal review groups were organized under the local comptrollers, with guidance and monitoring from the Comptroller of the Army who delegated this responsibility to the Army Audit Agency. [31:2]

In 1974, the internal review function was transferred to the Inspector General of the Army at the

Army Staff level; and likewise, the local internal review functions were placed under their respective Inspectors General. The Army Audit Agency was also reassigned to the Inspector General of the Army and retained its responsibility to monitor local internal review functions. [31:2]

In 1978, the Comptroller of the Army regained cognizance over internal review, while oversight responsibilities remained with the Army Audit Agency. Since 1978, most local internal review groups have been reorganized under their respective local comptrollers.

[31:2]

2. Current Organization

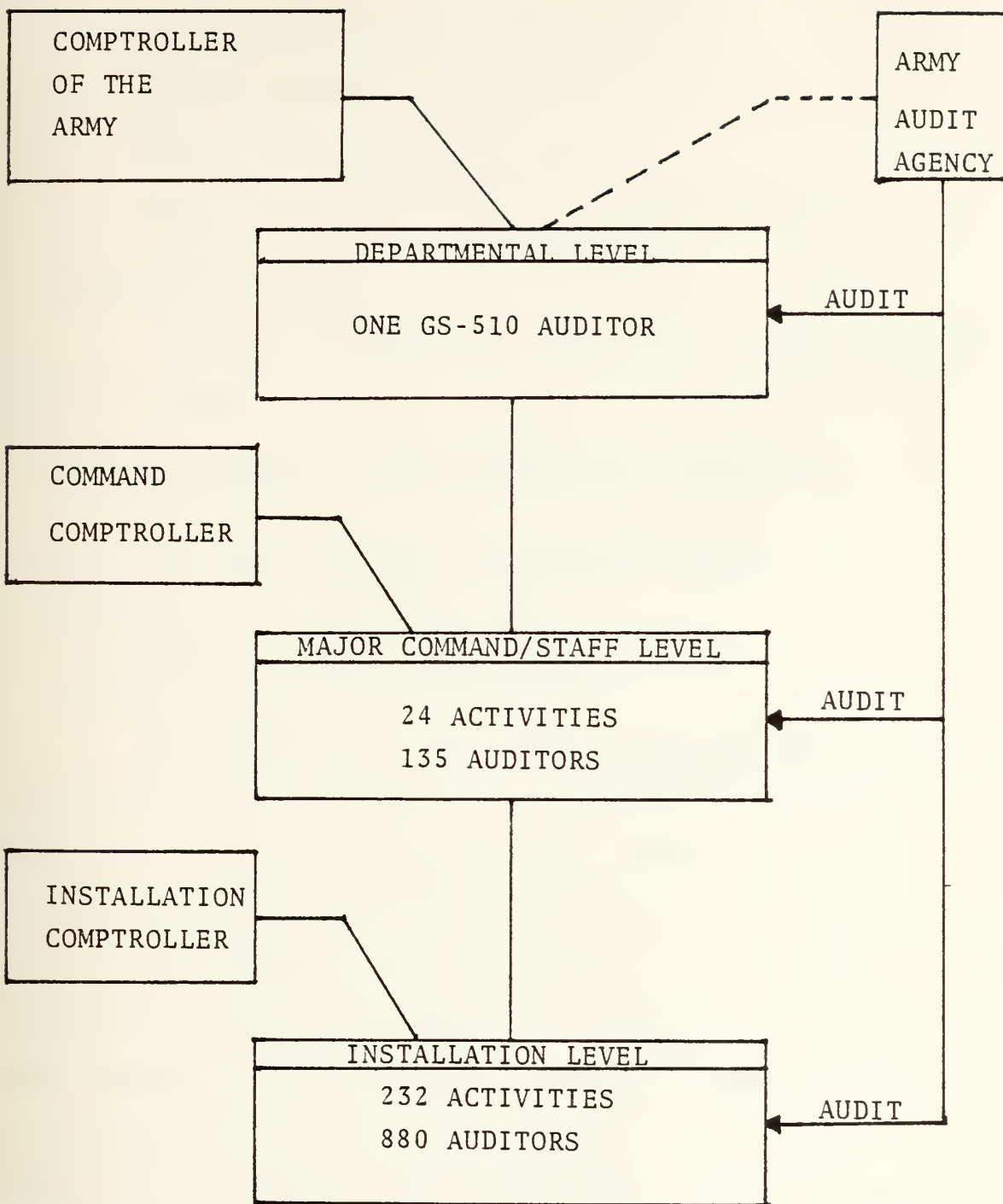
The Army internal review system consists of three hierarchical levels as shown by Figure III-1. At the departmental level, one GS-510 auditor is responsible, under the cognizance of the Comptroller of the Army, for:

[31:4]

- a. Promulgating policies and monitoring execution of internal review in the DA.
- b. Interpreting policy for internal reviewers throughout the DA.
- c. Prescribing the contents of technical audit training for internal reviewers in the DA.
- d. Distributing copies of Army Audit Agency audit regulations and circulars to all internal review groups.

At each of the major commands and Army Staff agencies, from two to sixteen internal review personnel:

[31:2]



U.S. ARMY
INTERNAL REVIEW ORGANIZATION

Figure III-1

- a. determine and issue policy.
- b. provide coordination.
- c. provide follow-up and liaison.
- d. plan and accomplish special request audits.
- e. monitor internal review activities at the installation level.

At most installations, from one to twenty internal reviewers have the major responsibilities of: [31:5]

- a. programming, audit planning and conducting audits of appropriated and non-appropriated funds.
- b. providing liaison with assistance teams from DA, major Army commands and external audit organizations such as the GAO.
- c. ascertaining if previously disclosed deficiencies have been corrected.

The Comptroller of the Army, through Army Regulation 11-7, has prescribed the role, responsibilities and scope of internal review throughout the DA. These policies are designed, in part, to create uniformity in the performance of internal reviews, subject internal review personnel to professional auditing standards, and promote the enhancement of internal review personnel's qualifications. [31:6]

The thrust of the Comptroller of the Army's program, is to increase the effectiveness of internal review by improving the caliber and performance of assigned personnel. [31:6]

The Comptroller of the Army monitors compliance with prescribed policies through on-site visits, by the one departmental level internal reviewer. [31:7] Each

command's internal review program is reviewed on a two or three-year cycle, with a written report submitted to the Comptroller. [31:7]

At the major commands and DA staff elements, the internal review function is responsible not only for reviewing the programs of its respective major command or DA staff element but also evaluating the internal review functions of subordinate commands and installations. [31:7]

In accomplishing this mission assignment, these internal review groups:

a. evaluate and monitor subordinate internal review functions by

1. examining and approving each installation's annual internal review program.
2. conducting annual or semi-annual surveillance visits of each subordinate internal review element in order to:

- (a) evaluate changes to annual program.
- (b) audit accomplishments.
- (c) monitor compliance.
- (d) ascertain problems in training or staffing.

A written report of the findings is made to the head of the local internal review group, who must respond through the local comptroller. [31:8, 9]

b. provide and interpret policy guidance to subordinate internal review functions. [31:9]

c. issue "Awareness Program" reports. These reports are basically a compilation of deficiencies disclosed by audits and reviews at installations within the major command. They list the most significant deficiencies in terms of dollar amount and frequency

of occurrence; and set forth actions necessary for correction. These reports are designed to encourage commanders who are not audited to examine their own operations and take remedial measures where required. The reports are not released to external audit groups or DA elements above the major command level. [31:9]

d. prepare internal review programs, perform audits, monitor audit compliance and provide liaison service for their respective command. [31:10]

At the installation level, the internal review function is designed to:

a. furnish the local commander with an independent appraisal of operations within the local command. [31:11]

b. assist installation activities in determining problem areas and deficiencies; and recommending corrective actions. [31:11]

c. act as the local command's focal point in monitoring audit compliance and providing liaison with external audit groups. [31:11]

The installation internal review function accomplishes these mission tasks by:

a. developing an annual internal review program of work and training. [31:11]

b. performing appropriated fund reviews including financial and compliance, economy and efficiency, and program results reviews. [31:12]

c. conducting non-appropriated fund audits. [31:14]

d. accomplishing follow-up reviews. [31:14]

e. providing liaison with all external audit teams. [31:15]

The Corps of Engineer's internal review group performs many of the same functions listed above; but also

has the assigned task of auditing civil works contracts, a responsibility shared only with the Defense Contract Audit Agency. [31:16]

In summary, the DA internal review function is a three-tiered hierarchical organization organized under the Comptroller of the Army. Each level has responsibility for the elements subordinate to it in the hierarchical structure; and are subject to evaluation and review themselves by the next higher hierarchical tier. The other missions and responsibilities of internal review in the DA are not substantially different from those described in Chapter II as applicable to DON.

3. Staffing

As of 30 September 1979, the DA had a total of 1,108 internal review billets. [31:18] 1,016 of these were auditors, and 92 were administrative slots. [31:18] The vast majority of the auditors were civilian; 1003, or 98.7 percent of the total. [31:18] The hierarchical distribution of auditors was as follows: [31:18]

- a. Department level - 1
- b. Major command level - 135 (average of 5.9 personnel per command)
- c. Installation level - 880 (average of 3.8 per installation)

For fiscal year 1979, the internal review costs within the DA were \$25.3 million for personnel, \$1.1 million for travel and \$0.6 million for other support; for a total of \$27 million. [31:18]

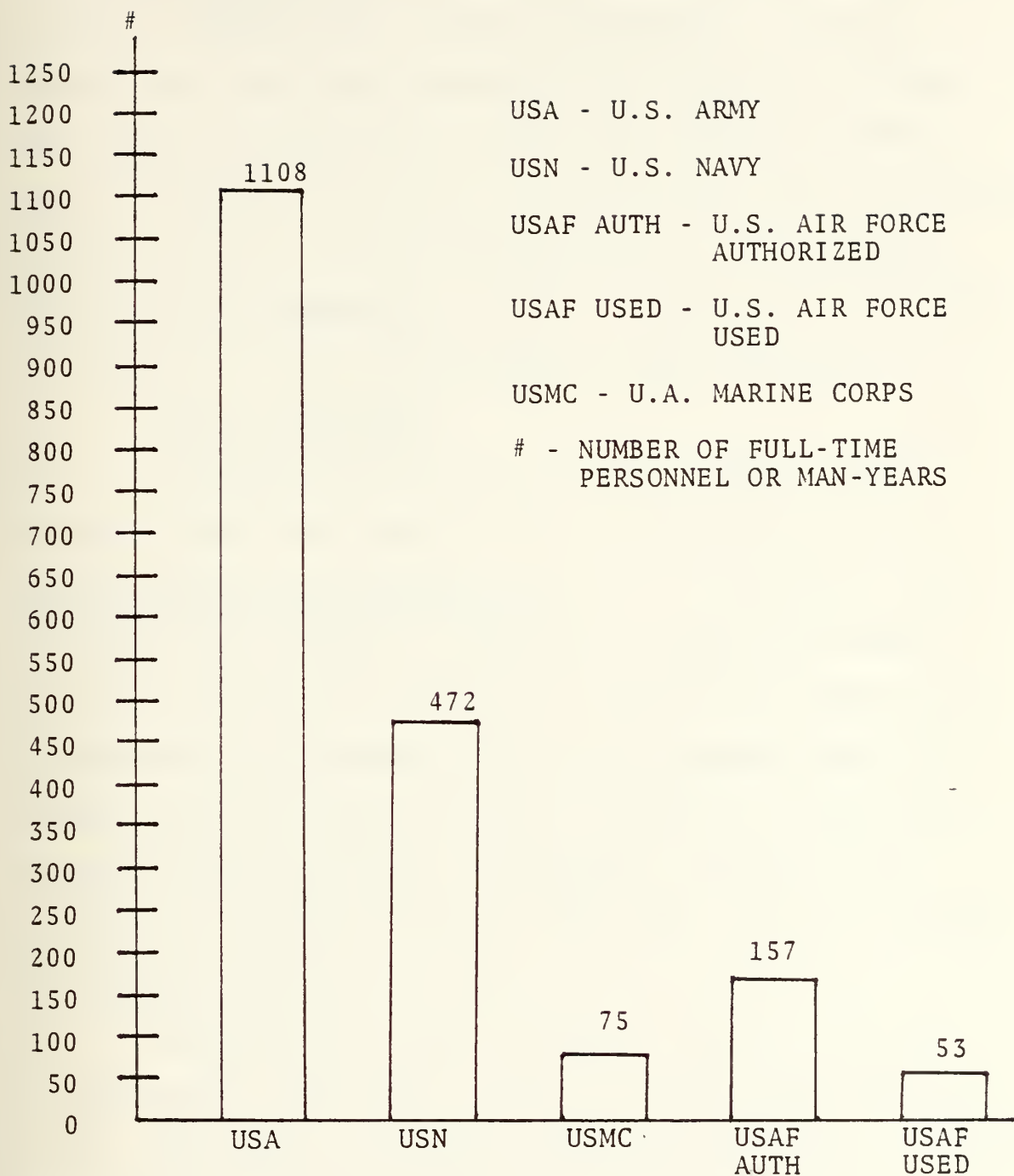
With respect to the numbers of personnel, the Comptroller of the Army recently conducted an analysis which concluded that 254 additional auditors were necessary for acceptable audit coverage. [31:19] Figure III-2 provides a graphic comparison of Internal Review Staffing in the DOD.

DA internal review personnel are required to be qualified auditors. [31:19] Applicants for positions must have the following qualifications: [31:19]

a. GS-5 auditor - Four years of college study including twenty-four semester hours of accounting and auditing, or possess a baccalaureate degree in accounting. Four years of professional accounting or auditing experience is an acceptable substitute for the educational requirements.

b. GS-7 auditor - In addition to the requisites above, must have completed one year of graduate study in accounting or auditing, or have at least one additional year of professional experience.

Training of internal review personnel in the DA consists of the usual on-the-job training, work assignment rotation, formal training classes conducted by the Army Audit Agency and other specialized training courses developed and sponsored by both the DA and outside agencies. [31:20] In the fiscal year 1978, 175 internal review personnel attended the classes offered by the Army Audit Agency; and in fiscal year 1979, the number of attendees were 244. [31:20] These classes covered such areas as automatic data processing, statistical sampling, logistic management and the financial aspects of procurement. [31:20]



INTERNAL REVIEW STAFFING
IN THE
DEPARTMENT OF DEFENSE

Figure III-2

The specialized training courses offered, cover audit subjects ranging from financial management, military accounting, planning, programming and budgeting systems, and operational auditing to basic and advanced automatic data processing. [31:21] In fiscal year 1978, 280 internal review personnel attended these courses; and in fiscal year 1979, 300 attended. [31:21] Figure III-3 provides a comparison between DA training and DON training.

4. Work Performance

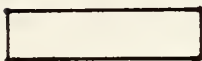
Internal review groups in the DA make use of standard Army Audit Agency audit programs to aid in improving their performance. [31:7] In addition, each internal review group is required to prepare an annual internal review program which is reviewed and approved to ensure that all mandatory reviews (non-appropriated fund audits and follow-ups of previous audits) are scheduled, appropriated fund areas are adequately covered, local commanders' requested work is performed, and that training is planned. [31:8]

Generally, speaking, the major command internal review groups spend most of their time performing duties other than audits, follow-ups and compliance work. [31:10] The reasons given for this, are staff limitations and the demands of other duties. [31:10]

ARMY

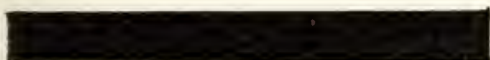


NAVY

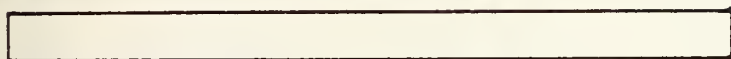


FORMAL/BASIC TRAINING

FISCAL YEAR 1979



244



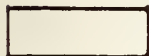
365*

SPECIALIZED TRAINING

FISCAL YEAR 1979



300



FEW**

* Concerning this figure, the Depute Comptroller of the Navy stated: "Obviously, many of these students were not members of formal internal review staffs. The individual commands control the selection of attendees and they tend to use the course for training any of their personnel involved in financial management." [11:136]

** The Task Force stated that in its review of the USN it: "found few internal review personnel who had been authorized to attend." [11:136]

INTERNAL REVIEW TRAINING
COMPARISON OF USA AND USN

Figure III-3

At the installation level, approximately 25 to 30 percent of auditor time is expended on reviews of appropriated fund activities. [31:12] Audits of non-appropriated fund activities consume approximately 25 to 40 percent of the available auditor time, much of which in mandatory reviews. [31:14] The regulatory requirement to conduct follow-up reviews of previous audit findings occupy approximately 25 percent of available auditor time. [31:14] The remaining 5 to 25 percent, is spent on items such as providing liaison with external audit organizations. [31:15]

During fiscal year 1979, the DA's internal review groups issued 6,803 reports. [31:18] Of the 3,430 reports issued during the first six months of the fiscal year, 456 (13.3 percent) concerned audits of civil works contracts and 998 (29 percent) dealt with either non-appropriated fund activities or follow-up reviews. [31:18] The remaining 2,081 (60.7 percent) dealt with appropriated fund activities, with over half (1,131 or 54.3 percent) resulting from reviews of such areas as fund controls and expenditures, material acquisitions, material and equipment storage and issues. [31:18]

The Comptroller of the Army has emphasized internal review's responsibility to ferret out waste, fraud and abuse during the course of every audit. [31:22] The procedures set up to handle disclosures of such situations

normally require the internal reviewer to advise the local comptroller and commander in writing of suspicious findings, inform local Criminal Investigation Command representatives, and, if appropriate, the chief of the reviewed elements. [31:22] The internal reviewer then withdraws from the engagement unless requested to continue by the local commander or an investigation. [31:22] During fiscal year 1979, internal reviewers of the DA used these procedures to report fraud or potential fraud in 48 instances. [31:22]

5. Summary

The "Task Force" has described the DA's internal review program as the "most vigorous" of the Defense Departments. [11:125] This description appears to be accurate from the data presented above and from a comparison with the other services (presented below). Notwithstanding the obvious organization, coordination, and hierarchical review procedures; the reader is reminded of the findings of the Study of the Operations and Relationships of Audit, Inspection and Review Groups in the Department of Defense, 3 November 1978, which stated, in part:

"In the Army . . . only 41 percent of the work done by these (internal review) activities met the minimal standards for audit. Audit programs normally were not prepared . . . and data collected . . . was often not sufficient to support the findings contained in reports." [11:135]

D. INTERNAL REVIEW IN THE DEPARTMENT OF THE AIR FORCE

1. General

The antithesis of decentralized internal review, as exemplified by the DA and DON, is the system established by the Department of the Air Force (DAF). Unlike her sister services, the DAF does not assign permanent internal review personnel to local commandres. [11:131] Instead, the Air Force Audit Agency (AFAA), under the "Commander Audit Program" (CAP), dedicates up to 15 percent of direct audit time to the special audit needs of local commanders that are not otherwise covered by the AFAA's ongoing cyclic audit efforts. [11:131] Based on current staffing levels, this equates to approximately 157 man years of internal review as compared to the DA's permanent assignment of 1,016 internal review auditors. [32:26]

2. Organization

The AFAA is organizationally located so that it reports directly to the Secretary of the Air Force. The Assistant Secretary of the Air Force for Financial Management provides technical guidance and supervision on audit policy and management matters. The AFAA also has direct access to the Air Force Chief of Staff (equivalent to USN's CNO). [32:26]

The AFAA itself, is a regional type organization similar to NAVAUDSVC with branches located at 85 Air Force

installations world-wide. [32:26] The mission of the AFAA is essentially the same as the Army Audit Agency or NAVAUDSVC, with the exception that it is the only formal organization within the DAF assigned to perform internal review type activities. [11:131]

Under the authority of Air Force Regulation 23-28, 23 May 1979; and Air Force Audit Agency Regulation 175-101, 31 October 1979; the AFAA can perform locally requested audits on behalf of the local commander of any function or activity within their jurisdiction provided that: [11:131]

- a. the audit is not conducted to gather data for use in responding to an inspection report;
- b. the audit is not for data reasonably available through command or other sources;
- c. the area in which the audit is requested has not been recently subjected to audit; or
- d. the request is not for an audit of non-appropriated funds.

The limitations described above, coupled with the perception by local Air Force commanders that resident AFAA auditors were "external," have resulted in what is essentially the establishment of informal internal review groups to provide the benefits described in Chapter II of this thesis. On this matter, the "Task Force" affirmed agreement with the Joint Department of Defense Study, Report of Survey of Utilization of Internal Review Personnel in the Department of Defense and Relationship to Internal Audit Function, dated 16 August 1967 which stated:

". . . Interviews with (Air Force) base commanders and/or comptrollers indicated that trouble-shooting and one-time studies were performed by either base management analysts, the responsible staff officer, operating activity, or an ad-hoc group appointed by the base commander." [11:145]

In summary, the internal review function in the DAF, is organized as an additional function of the centralized internal audit agency. The AFAA is limited by regulation to the expenditure of not more than 15 percent of direct audit time in the performance of these requested reviews; and also in the scope of the reviews. The affect of these limitations has been shown to be the establishment of informal ad hoc internal review groups at the local level, in order to provide the local commander with some measure of internal review's benefits.

3. Staffing

In fiscal year 1979, the AFAA had 1,044 auditors assigned with an audit budget of \$25,0 million. [32:26] This compares to other DOD centralized internal audit agencies as follows: [32:23-32]

- a. Army Audit Agency: 823 auditors, \$24.3 million
- b. Army Corps of Engineers: 150 auditors, \$4.5 million
- c. Defense Audit Service: 369 auditors, \$14.0 million
- d. Defense Contract Audit Agency: 2,910 auditors, \$90.0 million
- e. Marine Corps Field Audit Service: 112 auditors, \$2.4 million

f. Naval Audit Service: 552 auditors, \$17.3 million

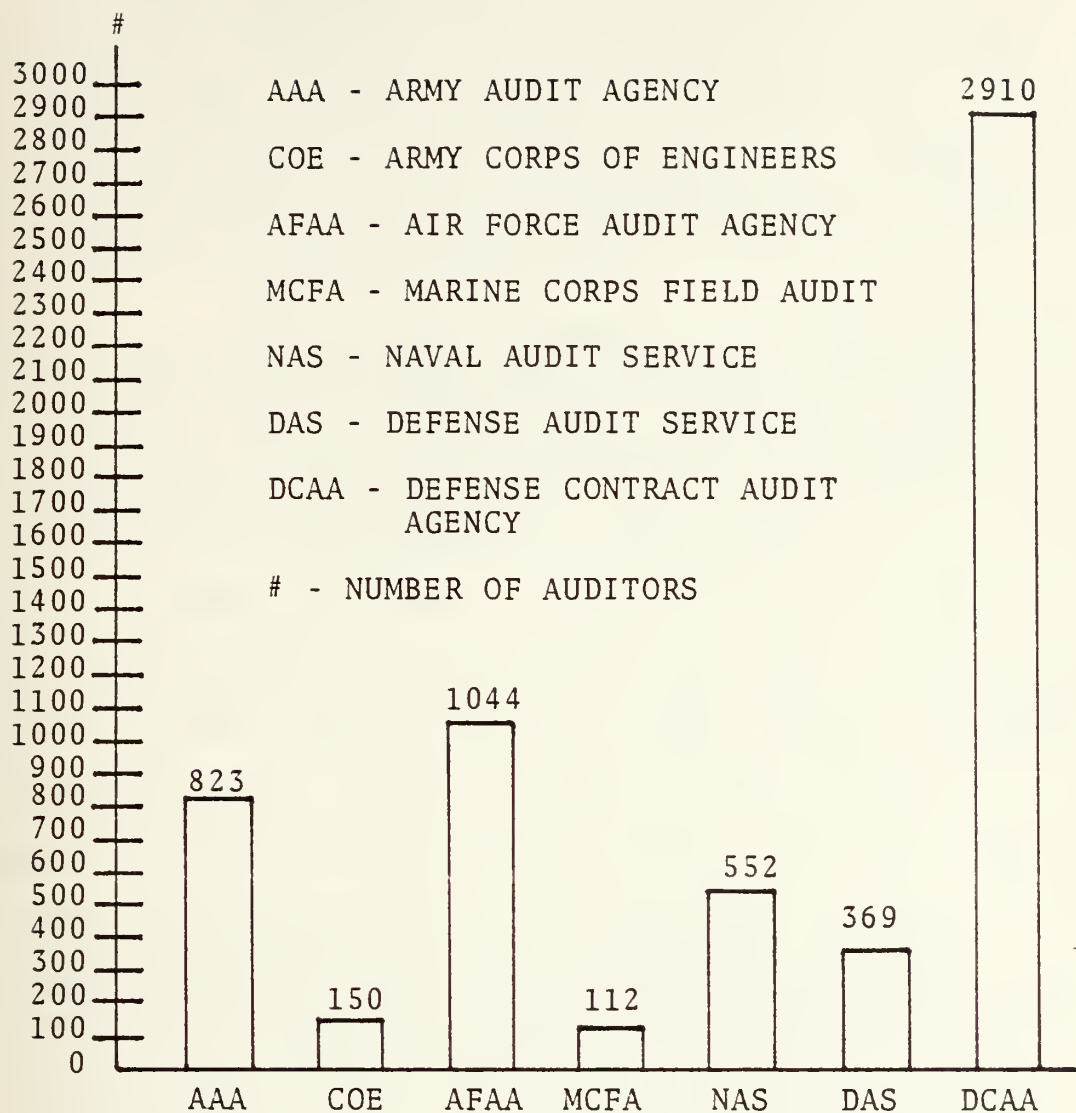
g. Total DOD: 5,960 auditors, \$177.5 million
(See Figure III-4 for a graphic display)

Excluding the DOD-wide organizations, the service departments in fiscal year 1979 had a total of 2,681 auditors, with annual budgets totaling \$73.5 million. Thus, of the uniformed services, the AFAA had 38.9 percent of the personnel and 34.0 percent of the total budget.

From these available 1,044 auditors, the AFAA had the authority to use 15 percent or 156.6 man years for the purpose of CAP or internal review. In actuality, CAP only accounted for 5.1 percent or 53.2 man years of direct audit time in fiscal year 1979. [11:148] Again, this compares to the 1,016 full-time auditors assigned to the DA's internal review groups. The AFAA has estimated, however, that it requires 575 additional auditors and 90 additional support personnel. [11:143] This would increase the total available man years for internal review functions by 86.2 to 242.8.

4. Work Performance

The "Task Force" again referred to the "Joint Study Group's" report in characterizing this area, by quoting the following criticisms of local Air Force commanders: [11:149, 150]



INTERNAL AUDIT STAFFING
IN THE
DEPARTMENT OF DEFENSE

Figure III-4

". . . recurring criticism (of DAF commanders and operating officials) was that many (internal) auditors seemed to dwell on finding and reporting deficiencies rather than determining solutions, and seldom made positive comments on portions of operations found to be satisfactory. . . Managers often believed they had a better method to correct the deficiency than was recommended by the auditors, but felt that the auditors did not adequately consider management's solution."

". . . Many managers commented that auditors were generalists rather than functional experts, and often were not sufficiently knowledgeable of functions being reviewed when they began an audit. As a result, operating personnel were required to spend an excessive amount of time briefing the auditors and answering their questions."

Conversely, from the higher echelons of the Government hierarchy, the GAO has expressly set forth the internal audit agencies' duty to place primary attention on "operational" audits of service-wide programs for economy, efficiency and effectiveness as follows: [11:143]

"The Audit Agency's use of scarce staff resources for secondary efforts (i.e., commander requested audits and audits of non-appropriated fund activities) and its allocation of one-half its total staff time to audits of financial management activities have significantly reduced its capability to perform its primary mission (i.e. audits for economy, efficiency and effectiveness) and decreased its value as a management tool." (quoted from GAO report No. FHMSD-77-49, "Why the Army Should Strengthen Its Internal Audit Function," 26 July 1976, p. 31)

5. Summary

Thus, it has been shown that the centralized internal review function, as it exists in the DAF, has been the subject of criticism from both upper and lower echelons. The local commanders, who, by regulation, depend upon the

AFAA to provide internal review services, have criticized the "external" nature of the agency, the manner and method of the conduct of an audit, and the lack of local knowledge by the auditors, leading to the increased inconvenience of local operating personnel. These local commanders, it has been seen, have in fact organized their own internal review groups using station personnel on an ad hoc basis.

The GAO on the other hand, has criticized the internal audit agencies for devoting too much time and effort to the secondary tasks of internal review type audits and audits of non-appropriated funds.

The centralized internal review function then, is caught in a true paradox of notable importance: The lower echelon avoids the use of the service; and the higher echelon criticizes the service which is provided. As evidenced by the CAP utilization statistics presented above and the selective attitude of internal audit agencies given in Chapter II, the net result is apparently a significant decrease in the conduct of internal review by "qualified" personnel.

E. INTERNAL REVIEW IN THE U.S. MARINE CORPS

This section will present the findings of a recent survey of internal review in the U.S. Marine Corps (USMC) conducted by Lieutenant Colonel John C. Baggette, USMC. The survey formed the basis for Lieutenant Colonel Bagette's

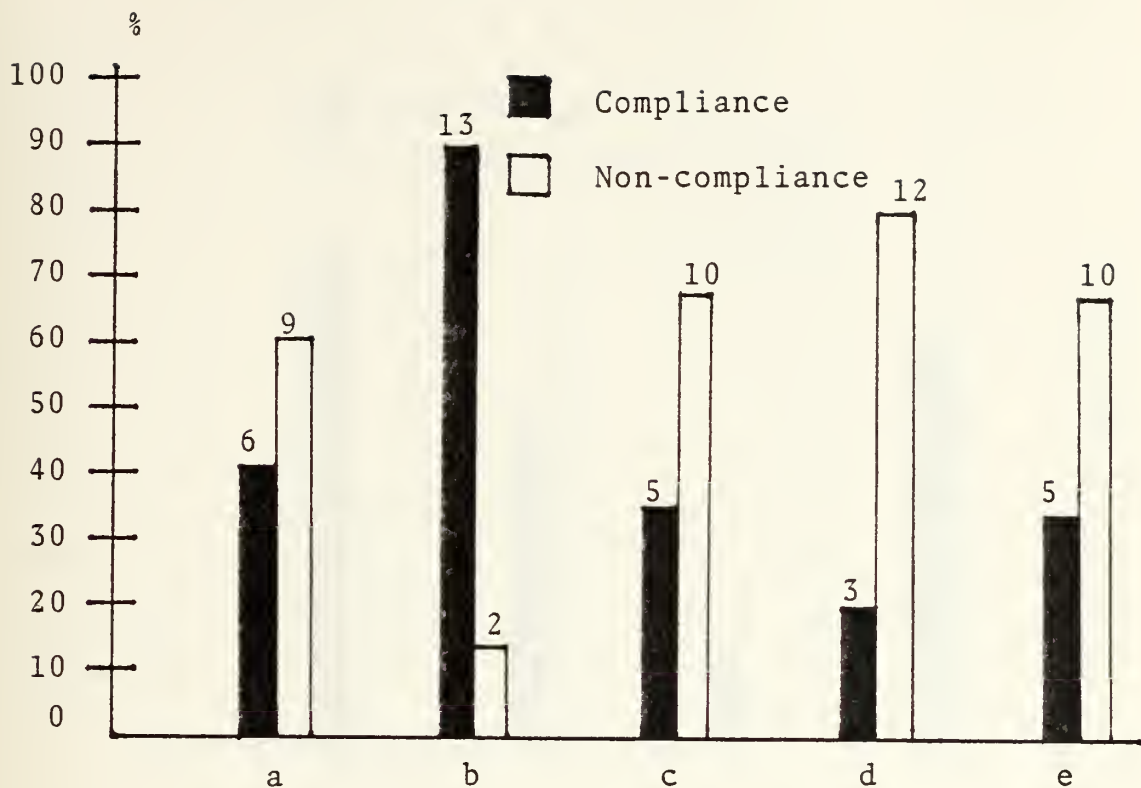
Master of Science in Management Thesis at the Naval Postgraduate School, Monterey, California. The thesis is entitled "A Survey of Internal Review in the U.S. Marine Corps;" and is dated June, 1980. [20] All quotations and paraphrased material, unless otherwise indicated, come from Lieutenant Colonel Baggett's work.

1. General

Lieutenant Colonel Baggett's total population consisted of 27 USMC internal review groups; 15 shore activities, and 12 operational activities. The survey sampled 55 percent of this population, or 15 activities. [20:42] In conducting the survey, a questionnaire consisting of 25 questions grouped under four major areas was used in order to organize data. The four major areas surveyed were staffing, organization, work performance, and reporting. Figures III-5, III-6, III-7, and III-8 are slightly modified versions of the originals; and graphically display the results of the survey. The data displayed corresponds to the survey questionnaire, which is reprinted as Appendix A to this thesis.

2. History

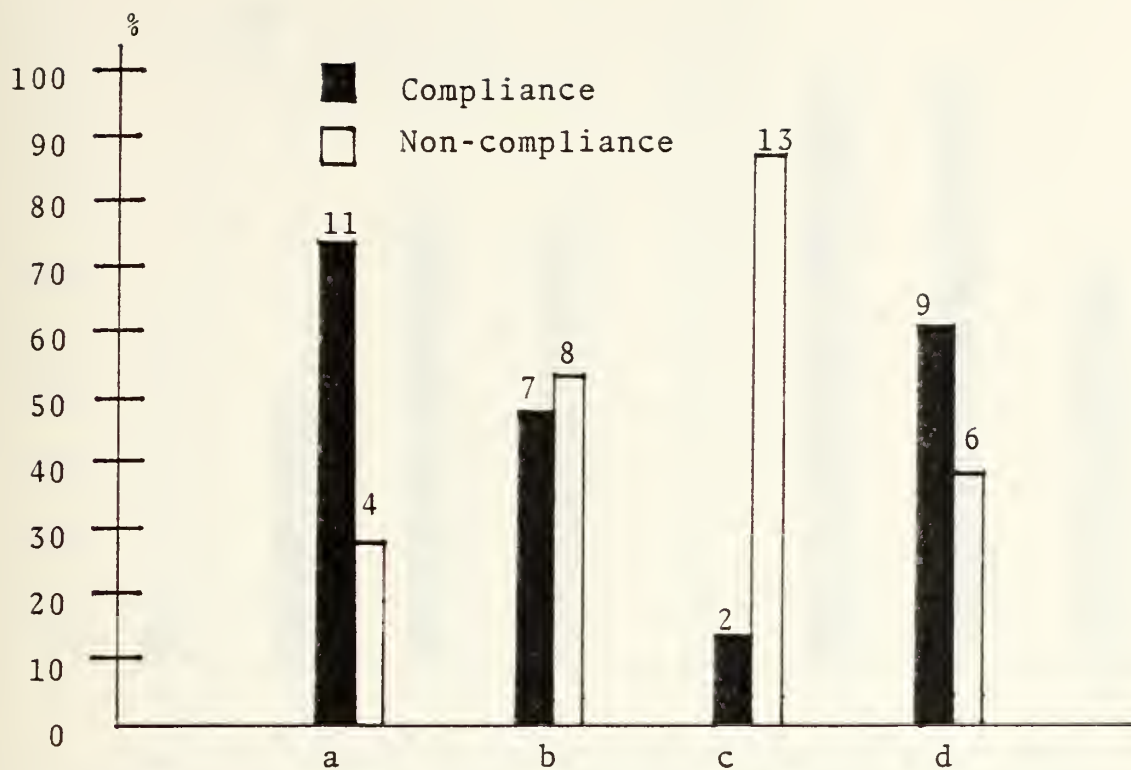
As a component of the DON, the USMC's implementation of internal review is the same as that previously outlined in Chapter II of this thesis. All DOD and SECNAV directives, instructions, and other guidance apply equally to the USMC and the USN. In addition, the USMC has provided



- a. Are sufficient personnel assigned to accomplish the intent of internal review?
- b. Do assigned personnel have the necessary technical qualifications authorized?
- c. Do the working papers reflect the necessary technical competence?
- d. Is adequate training provided on a continuing basis?
- e. Is adequate supervision provided?

USMC INTERNAL REVIEW STAFFING

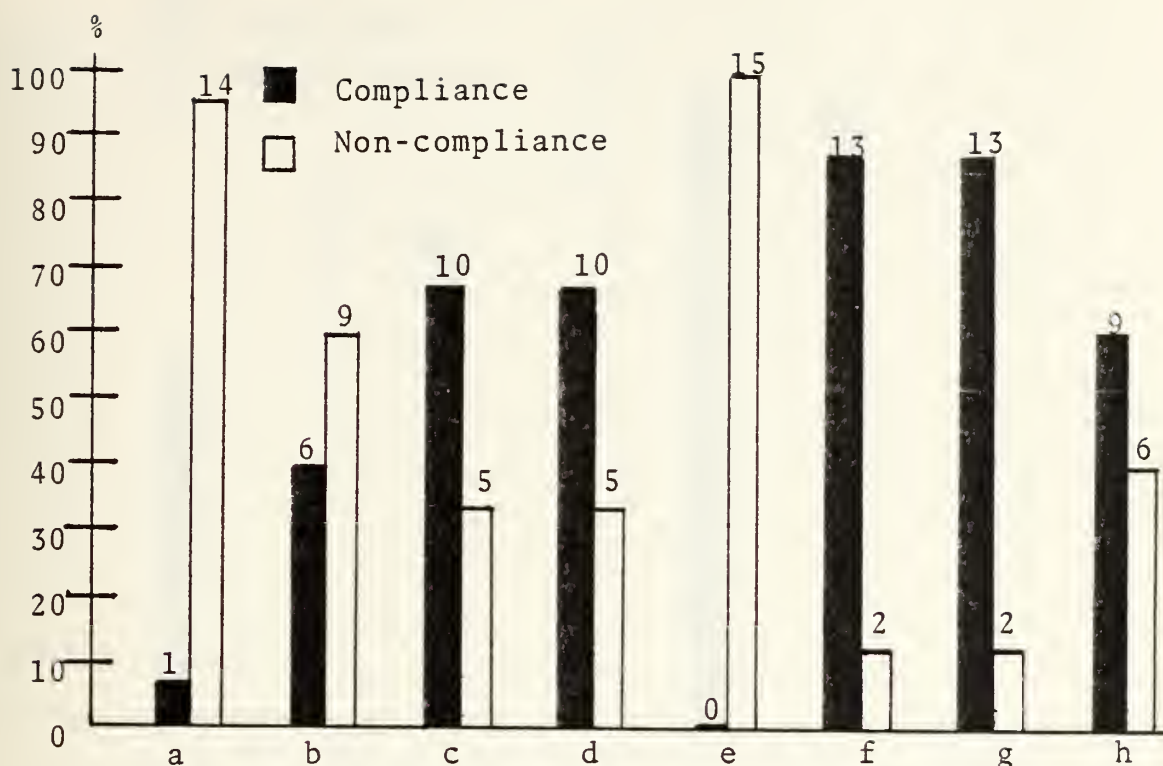
Figure III-5



- a. Is internal review authorized in a local regulation?
- b. Does internal review have its own budget?
- c. Have steps been taken to avoid intentional duplication with NAVAUDSVC activities?
- d. Does the internal review staff have complete independence in order to make recommendations free of pressures from other management personnel?

USMC INTERNAL REVIEW ORGANIZATION

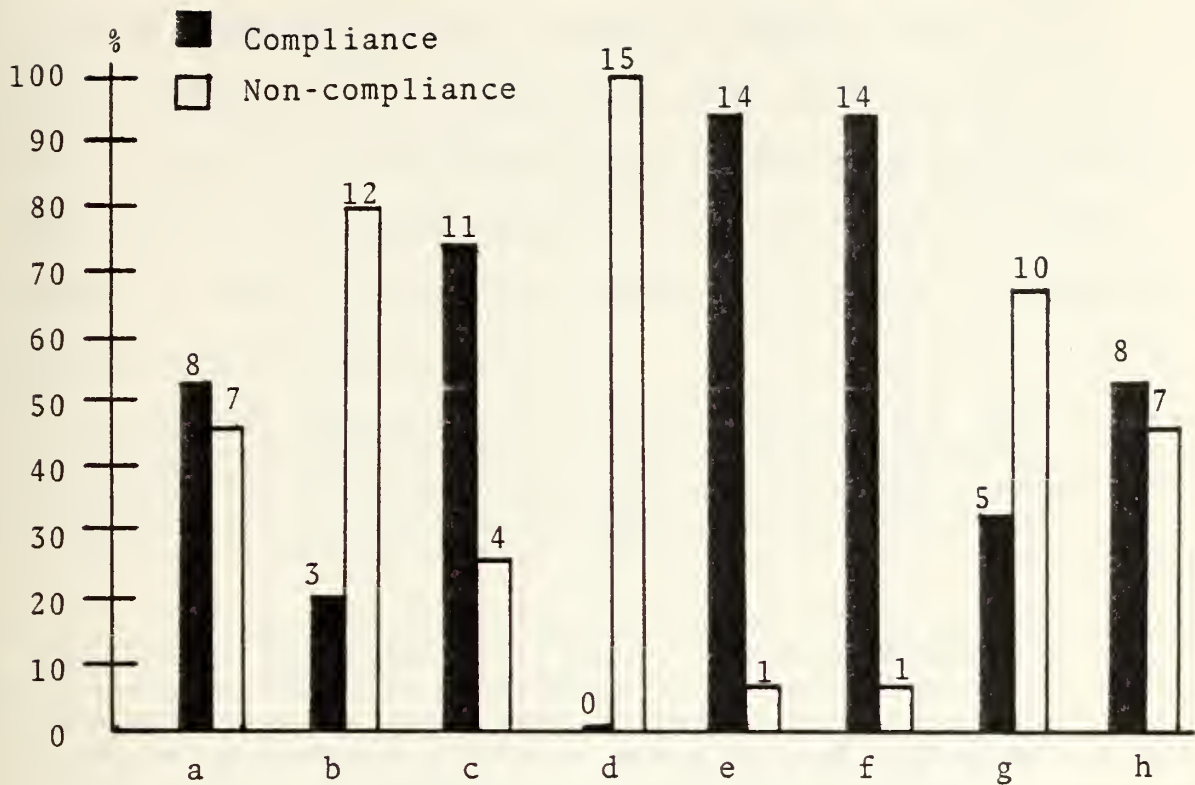
Figure III-6



- a. Is there an annual internal review program that ensures scheduling of those areas of mandatory and traditional audit coverage and allows for operational studies and reviews especially in area that may lend themselves to fraud or waste?
- b. Is the audit coverage of functional areas performed by internal review satisfactory?
- c. Does internal review accomplish the required audit liaison and follow-up actions?
- d. Are internal reviews performed properly?
- e. Do the working papers properly document the reviews?
- f. Are internal review programs and objectives revised to reflect changing conditions?
- g. Are internal review activities directed toward appropriate projects rather than clerical tasks?
- h. Does internal review provide orientation training on the provisions of R.S. 3679 to newly assigned personnel who will be dealing with appropriated funds?

USMC INTERNAL REVIEW WORK PERFORMANCE

Figure III-7



- a. Are internal review findings and recommendations reported to the commander properly?
- b. Does the commander get involved in correction of reported deficiencies?
- c. Does internal review enjoy the support and acceptance of the commander?
- d. Are findings dollarized where practical?
- e. Are findings usually accepted?
- f. Are recommendations usually accepted?
- g. Do internal review reports require a response by the reviewee?
- h. Are reports followed up as to whether deficiencies are corrected and recommendations considered?

USMC INTERNAL REVIEW REPORTING

Figure III-8

further guidance through a series of Marine Corps Orders (MCO) issued by the Headquarters, U.S. Marine Corps. The most notable of this supplemental guidance is contained in MCO 7540.2A, dated 24 September 1979, entitled "Internal Review." This document has stated the purpose of internal review in the USMC as follows:

"To provide commanders and organic capability to examine, analyze, evaluate and explore those areas of operations where known or potential problem areas exist which may adversely affect the efficient and economical use of command resources.

Internal review represents an extension of the financial management responsibilities of commanders to ensure that the commitment of resources is in accordance with prescribed statutory requirements and in conformance with the policies and procedures directed by the Commandant of the Marine Corps. Within the context, the internal review function will periodically assess the effectiveness of prescribed internal control procedures, not only for, the accountability, recordation, certification and expenditure of appropriated funds, but also for the effective use of personnel resources and the control of command property, materials and supplies. -

The effective use of internal review will not only provide commanders a means for assessing the adequacy and quality of internal command operations, but will also serve as the basis for the timely detection and correction of unsatisfactory conditions and practices." [33: 1, 2]

The above description emphasizes the "organic" nature of internal review in the USMC; and its position as an "extension of the financial management responsibilities of commanders." It further delineates the financial and compliance, economy and efficiency, and program results

(effectiveness) responsibilities of internal review; as these categories were described previously by this thesis.

The next sections will provide the results of the Baggette survey grouped into the major areas of staffing, organization, and work performance. The findings will be presented succinctly. The reader should refer to Lieutenant Colonel Baggette's thesis for a more complete discussion of individual findings.

3. Organization [20:62]

a. Independence

The survey found that 73 percent of the internal review groups were locally chartered; and that approximately 50 percent of the groups had a separate budget. However, the groups were not perceived as unbiased, objective, and independent organizations with free access to the local commander.

As stated previously in this thesis, the "appearance" of independence is regarded by professional auditors as being as equally important as de facto independence. [35:40] The organizational position of the internal review group within the local command, does much to either enhance or detract from the perception of independence. The Institute of Internal Auditors (IIA) has listed the concept of independence as the first of its five areas of concern for internal auditors. The IIA's

Standards for the Professional Practice of Internal Auditing lists this area as: "the independence of the Internal Auditing Department from the activities audited and the objectivity of internal auditors." [15:27]

Thus, the location of the internal review function in the office of the comptroller in accordance with DON policy, [10:1] probably amounts to a fatal flaw. [20:62]

b. Authority

The survey determined that through both local regulation and command support, the surveyed activities had the necessary authority to accomplish the intent of the regulations.

4. Staffing

a. Sufficiency of Assigned Personnel [20:59, 60]

Eighty-one percent of the authorized internal review billets were filled as of September, 1979; but only 40 percent of the activities surveyed considered the authorized levels to be satisfactory. The activities surveyed also indicated, that as the government-wide campaign against fraud, waste and abuse intensifies, this level of satisfaction would be further eroded. In addition, it was opined by these same activities, that the increased scope of internal review (as defined by MCO 7540.2A of 24 September 1979) would also contribute to the future inadequacy of the authorized billets.

The survey also found that, contrary to USMC policy, the internal review groups were universally reluctant to employ ad hoc, temporary or part-time reviewers from outside the internal review organization.

b. Technical Qualifications [20:60]

The survey found that most personnel assigned to the internal review positions had the required technical qualifications. However, many activities questioned the adequacy of these requirements in general and for enlisted personnel in particular. The survey's findings on working papers, coupled with the Task Forces' finding which states: "We reviewed five reports and workpapers and found that minimal audit standards have been met in one;" [11:135] seem to bear strong witness to the truth of this inadequacy. Lieutenant Colonel Baggette conveyed the importance of proper qualifications when he stated: ". . ., internal-review personnel will function more like auditors than troubleshooters in the future and will need the skills to match the task." [20:60] The "task," has been clearly and cogently communicated by the recent actions of President Reagan. Within hours of his inauguration, the President ordered that the 15 executive departmental inspectors general be replaced by, as spokesman James Brady described it, people who are "meaner than a junkyard dog in ferreting out waste, fraud and mismanagement." [34:15]

c. Training [20:61]

The survey found that only 20 percent of the activities were meeting the compliance standard. The reason most often stated was either lack of resources or training opportunities.

d. Supervision [20:61]

The survey found the perception that supervision was inadequate. This is evidenced by the fact that two-thirds of the internal review groups surveyed, complained about a lack of performance feedback.

5. Work Performance

Ninety-three percent of the activities surveyed, did not adequately schedule necessary reviews such as those identified by the Naval Audit Service's (NAVAUDSVC) internal review audit program. This audit program (Number thirty-two) identifies several areas considered mandatory in countering fraud and waste, such as civilian payroll and timekeeping, accountability and control of plant property, procurement, supply management, and management of transportation equipment.

The survey also found total non-compliance with General Accounting Office (GAO) standards for working papers. These standards require working papers to be complete and accurate, clear and understandable, legible and neat; and contain only matters materially important, pertinent and useful.

Based on four criteria, [20:64] the survey concluded that only about 40 percent of the activities were in compliance with established effectiveness measures.

- a. Only 53 percent of the activities correctly reported the results of the reviews conducted to the local commander.
- b. None of the activities surveyed regularly attempted to dollarize review findings in order to better project the magnitude of a problem to the local commander.
- c. Only one-third of the surveyed activities had any procedure established to ensure the reviewers acknowledged the report in writing.
- d. Less than half of the activities surveyed had any program of follow up established to check and report on corrective actions taken.

6. Summary

This section has shown the "organic nature of internal review in the USMC and provided the reader with its defined scope.

In presenting the findings of Lieutenant Colonel Baggette's survey, the section has shown deficiencies in all four major areas, but most notably in those of organization, work performance and reporting. In this author's opinion, the deficiency in staffing probably could be overcome in the short run through increased effective use of ad hoc personnel. However, the increased visibility of the internal review function regarding the elimination of waste and fraud, not to mention the task itself, will most likely result in the necessity to increase authorized billets.

A deficiency in organization has been shown to be lack of apparent independence. This deficiency was also shown to be one pervading even the private sector to such an extent as to warrant top billing in the IIA's list of major concerns. The primary contributor to this misappearance of independence was shown to be the organizational location of the internal review function.

The deficiencies associated with the areas of work performance and reporting are numerous; but the survey commented that the majority could be resolved through more effective training of internal review personnel, to include revisions of qualification criteria.

In short, while the internal review in the USMC has been shown to be ineffective in several major areas, the solutions are feasible and certainly well within the realm of accomplishment. The internal review function was shown by the survey to be responsive to the local commander's needs and directed towards appropriate projects.

F. INTERNAL REVIEW IN THE U.S. NAVY

1. Background

Prior to 1976, the only central direction regarding internal review in the DON was contained in volume I of the Navy Comptroller Manual. [36:1] That Manual specified that internal review was a comptrollership function consisting of eight financially oriented functions

conducted mainly within the comptroller area. [36:1]
Internal review was specified to be the responsibility of each command. No other USN organization was assigned any responsibilities regarding internal review. [36:1]

The issuance of SECNAVINST 7510.8 in October, 1976 re-emphasized the need for internal review in the DON, and broadened its scope to include any areas subject to inefficiency, misapplication of funds, fraud or theft. [36:1]
This instruction also tasked various headquarters elements to issue supplemental guidance; and charged the Auditor General of the Navy with the responsibility for developing and conducting training; and for providing technical guidance to internal review personnel. [36:1]

More recently, the acting Comptroller of the Navy (NAVCOMPT), RADM S. D. Frost, SC, USN referred to the need for an effective internal review function by stating: -

" . . . with the establishment of an effective internal review program, great strides can be made in eliminating waste, fraud and abuse in Government expenditures . . . In an era when funds and ceiling points are constantly being cut, a good internal review staff will more than pay for itself."
[30:2]

In the same issue of the Financial Management Newsletter, LCDR R. A. Bobulinski, SC, USN reported that:
" . . . a Navy Department official noted that internal review capability in the Department of the Navy (DON) was only about 15 percent effective . . ." [40:27]

In view of the demonstrated high level advocacy of internal review in the DON, the author concurs with LCDR Bobulinski's question concerning the status of internal review in the DON: ". . . why is this the case?" [40:27]

This section will attempt to provide evidential matter from which the reader may gain insight into this apparent gap between high level advocacy and low level implementation.

This section will review the current status of internal review in the U.S. Navy (USN) as determined by the NAVAUDSVC in its fiscal year 1979 "Internal Review Audit Emphasis Program." [36] Under this program, NAVAUDSVC required its auditors to examine the performance of the internal review groups during each periodic or continuous audit. [36:2] During the period covered (FY 1979), 142 activities, including all major USN activities, were examined. [36:2] These 142 activities had a total of 215 full-time and 35 part-time internal review personnel, which represented approximately one-half of the full-time personnel assigned to the USN's internal review program. [36:2]

This section will be organized into the areas of organization, staffing and work performance. The reader is requested to refer to the previous section on internal review in the DA for comparisons and contrasts.

2. Organization

The Task Force, in comparing internal review in the USN with internal review in the DA, stated: "Naval internal review also differs from its counterpart in the Army in that it is totally decentralized." [11:128]

The NAVAUDSVC report has summarized this decentralization as follows:

"The basic philosophy of the Navy is that internal review is an essential element of a commanding officer's system of management control within his activity. (emphasis added) The type of personnel to be used, the use of full-time or part-time personnel and the precise nature of the functions performed generally is left to the discretion of each commanding officer. (emphasis added)"

No staff element of the Navy Secretariat is assigned any specific responsibility for internal review policy, except for that responsibility placed on the Auditor General to develop and conduct training and to provide technical guidance. (emphasis added) Based on the definition that internal review is a fundamental element of comptrollership, it may be inferred that the Navy Comptroller should be responsible for the function, but no one in that office is charged with any such responsibility.

The Chief of Naval Operations has issued no directives on internal review and no one in his office has been assigned responsibility for the function.

The Headquarters, U.S. Marine Corps has issued a directive (MCO 7540.2A), as have most of the Navy Systems Commands. These directives provide policy for implementation of the internal review function at subordinate activities." [36:1, 2]

The following excerpts from SENCAVINST 7510.8 dated 15 October 1976 clearly show the intention of

SECNAV that internal review in the USN be decentralized to the lowest echelon:

"The Internal Review function is designed to provide Commanders, Commanding Officers, and Comptrollers with an independent in-house capability . . ." [10:1]

". . . Recipient (of funds) Commanders and Commanding Officers are personally responsible thereunder for proper funds administration. The function of Internal Review is implicit in this responsibility." [10:1]

"It is the policy of the Secretary of the Navy that an Internal Review function . . . , be implemented at all appropriate installations and activities . . ." [10:1]

". . . the Internal Review function should be organizationally placed in staff capacity to the Comptroller or such other official who may be assigned responsibility for administration of funds. However, should circumstances so warrant, the organizational placement of the Internal Review functions should not preclude direct liaison with the Commander or Commanding Officer." [10:1]

"The objective of the Internal Review function is to aid the Commander, Commanding Officer or Comptroller in their role as funds administrators. . ." [10:2]

"Resources for execution of the Internal Review responsibility will be made available from within available resources." [10:2]

"Designation of . . . (type of personnel) is a function . . . of each command." [10:2]

"Implementation of the Internal Review function is a command responsibility." (emphasis added) [10:3]

The NAVAUDSVC reported that, of the 85 activities with established internal review functions reviewed, 63, or over 74 percent, had located the internal review function organizationally under the local comptroller. [36:3]

The organizational positions of the internal review functions in those activities surveyed by the NAVAUDSVC, that in fact had established internal review functions, are shown in Figure III-9.

The NAVAUDSVC determined that of the 142 activities surveyed, 106 (or 75 percent) were of sufficient size and complexity to require an internal review function. [36:2] Of those activities, 20 percent of them (21 in numbers) had not established an internal review function. In other words, based on a sample size of approximately 50 percent, there is only an 80 percent compliance rate in the USN for establishing an internal review function when one is in fact necessary.

In attempting to explain this rate of non-compliance, the NAVAUDSVC offered the following:

"... it is reasonable to believe that it (non-compliance) is due to a local command's decision that the billets or resources that would be required to expand or establish an internal review program are not justified. (emphasis added) This may be due to a failure of the command to understand or appreciate the benefits that an effective internal review program can accomplish." [36:3]

This discussion has shown that the internal review function in the USN is totally and intentionally decentralized. It has also been shown that only approximately 80 percent of those USN activities needing an internal review function have in fact established one. The NAVAUDSVC opined that local commanders perhaps are not fully aware of

<u>LOCATED UNDER:</u>	<u>NUMBER</u>	<u>PERCENT</u>
Comptroller	63	74.1
Commanding Officer	9	10.6
Resources Manager	2	2.4
Supply Officer	3	3.5
Budget	1	1.2
Accounting Systems Officer	2	2.4
Management Support Division	1	1.2
Investigator	1	1.2
Undetermined	3	3.5
TOTALS	85	100.0

ORGANIZATIONAL POSITION OF
USN INTERNAL REVIEW FUNCTION

FIGURE III-9

the benefits of an effective internal review program, and offered this as a reason for non-compliance decisions by local commands. Based on these facts, the NAVAUDSVC concluded in part: "The policies outlined in SECNAVINST 7510.8 are only being partially accomplished;" [36:3] and "Many Naval activities have not established an internal review program . . ." [36:3]

3. Staffing

The Secretary of the Navy's implementing instruction, SECNAVINST 7510.8, states:

"Designation of either qualified full-time, part-time, or collateral duty personnel for Internal Review is a function of the size, mission and complexity of operation of each command." (emphasis added) [10:2]

and adds as a separate item:

"Resources for execution of Internal Review responsibility will be made available from within available resources." [10:2]

Additional staffing guidance is provided by Enclosure (2) to SECNAVINST 7510.8 which is entitled:

"Staffing and Training the Internal Review Function."

This policy document states:

"The nucleus of the Internal Review staff should be an interdisciplinary group collectively possessing adequate professional proficiency for the tasks required. This acknowledges temporary assignment of additional personnel on an ad hoc basis to provide a particular internal review study. Typically, the disciplines represented in an internal review staff would consist of (1) financial management, and (2) the dominant technical, scientific or management skill represented by the command mission.

The size and complexity of operations of the individual command will determine the mix and ratio of the personnel required with respect to grade/rank, experience/classification, and whether full-time or part-time/collateral duty." [10:encl. 2]

Regarding the training of internal review personnel, SECNAV has stated that, "Proper training is essential for effective performance and vital to the acquisition of new skills that are required to audit a broad range of subjects for the Command." [10:encl. 2] SECNAV also envisions a training function to be performed by the internal review function itself:

"The Internal Review function provides an invaluable training ground for development of future financial management talent. (emphasis added) Consequently, training should include not only auditing fundamentals and techniques of critical review and examinations, but also new areas of management interest such as use of ADP (automatic data processing) application for data sampling and data retrieval." [10:encl. 2]

In its examination of internal review in the USN, the Task Force found that:

"A vast amount of (internal) review is conducted at smaller activities by people on an ad hoc/collateral duty basis. Many of these smaller entities conduct reviews from an audit board concept. These standing (audit) boards periodically review a specifically assigned function. One board may review only the financial soundness of one non-appropriated fund element (e.g. the Commissioned Officers' Mess, Open) or another (audit board) review civil timekeeping. Reports generated in this manner are consistent in their distribution with the larger more formal activities." [11:130]

For the reader's edification, perhaps the best and most widely known example of the audit board concept

is the "Cash Verification Board," which periodically (monthly and/or quarterly) conducts a surprise examination of a DON Disbursing Officer's Official accounts. Each command having an accountable disbursing function is required by the Comptroller of the Navy Manual, Volume IV to establish a Cash Verification Board. This manual also provides explicit directions for both the make-up and conduct of the board, including sample reports and report distribution. Membership on this board is a collateral duty assigned by the local commander.

In its report on internal review in the USN, the NAVAUDSVC determined that approximately 86 percent of the personnel assigned to the internal review functions examined were full-time personnel. [36:2] Of these full-time reviewers, over 98 percent were civilian employees. [36:2] Part-time reviewers accounted for 14 percent of the personnel assigned; and approximately 90 percent of these were also civilian employees. [36:2] Military personnel accounted for just over 3 percent of all personnel assigned; and all but one of these were assigned as heads of their respective functions. [36:2] In fact, only one of the activities surveyed had an internal review function staffed entirely by full-time military personnel. [36:3]

Figures III-10 and III-11 summarize the internal review staffing of the activities examined by the NAVAUDSVC. The statistics shown do not include those personnel assigned to the internal review function on an ad hoc basis, or assigned to the various local audit boards.

While the NAVAUDSVC report does not comment directly on the adequacy of current staffing levels, a perusal of attachments A through D of the report reveals several instances of staffing shortages or other problems purported by the NAVAUDSVC to be examples of "typical findings" of the reviews conducted. [36:3] This leads one to assume that staffing inadequacies may be considered, however tenuously, to be to some degree "typical" of internal review in the USN.

This section has provided the reader with DON's policy regarding the staffing of the internal review function; and has summarized the results of the NAVAUDSVC's review. The reader was also introduced to another much used facet of internal review in the DON, the audit board concept.

The next section will deal with the performance of internal review groups in the USN in the discharge of their assigned responsibilities.

<u>GRADES</u>	<u>FULL-TIME</u>		<u>PART-TIME</u>		<u>HEAD</u>	
	<u>NO.</u>	<u>%</u>	<u>NO.</u>	<u>%</u>	<u>NO.</u>	<u>%</u>
GS-3	1	0.5	-	-	-	-
GS-4	1	0.5	1	2.9	-	-
GS-5	10	4.6	-	-	-	-
GS-6	-	-	1	2.9	-	-
GS-7	18	8.3	4	11.4	-	-
GS-8	1	0.5	-	-	-	-
GS-9	41	19.0	4	11.4	5	6.4
GS-10	-	-	1	2.9	-	-
GS-11	72	33.3	11	31.4	24	30.8
GS-12	44	20.4	6	17.4	21	26.9
GS-13	22	10.2	-	-	17	21.8
GS-14	2	0.9	2	5.7	3	3.8
GS-15	-	-	1	2.9	1	1.3
CPO	1	0.5	-	-	-	-
LT	2	0.9	1	2.9	3	3.8
LCDR	1	0.5	2	5.7	3	3.8
CAPT	-	-	1	2.9	1	1.3
TOTALS	216	100	35	100	78	100

GRADES OF PERSONNEL ASSIGNED
TO USN INTERNAL REVIEW FUNCTIONS

Figure III-10

<u>ACTIVITIES' STAFFING</u>	<u>NUMBER</u>	<u>PERCENT</u>
Totally by full-time civil servants	49	57.6
Full-time civil service and military	3	3.5
Totally by full-time military	1	1.2
Totally by part-time personnel	17	20.0
Full-time civil service supplemented by part-time personnel	5	5.9
Full-time civil service supplemented by foreign nationals	3	3.5
Totally staffed by foreign nationals	7	8.2
	<hr/>	<hr/>
Totals	85	100

SUMMARY OF CHARACTERISTICS OF USN
ACTIVITIES WITH INTERNAL REVIEW FUNCTIONS

Figure III-11

4. Work Performance

In summarizing internal review in the USN, the Task Force offered the following general characterizations:

"First, the role assigned naval internal review personnel varies considerably from one installation to another. Second, the analyses performed by naval internal review personnel are primarily limited to the comptroller area. The Army, by contrast, uses its internal review personnel to address aspects of all functional areas within the command." [11:129]

The NAVAUDSVC, in its report on internal review in the USN found that:

"Of the eighty-five activities with established internal review functions, 41 or 48 percent limited the internal review staff to audits of non-appropriated fund activities, payroll functions, and/or certain financial areas." [36:2]

Regarding the above findings, the NAVAUDSVC stated that:

"By limiting the scope of the reviews, the activity also limits their value to management and fails to meet the objectives of SECNAVINST 7510.8 which emphasizes that internal review is responsible for examining internal management controls, practices, and procedures at all levels to determine adequacy in concept and effectiveness in application." [36:2]

In addition to the above requirements, Enclosure (1) to SECNAVINST 7510.8 provides the following functions to be performed by internal review. (paraphrased from the cited document)

a. Insure that there is provision for financial integrity and effective utilization of all available command resources.

- b. Audit the civilian timekeeping and payroll function; and certain non-appropriated fund activities.
- c. Monitor the correction of deficiencies revealed by external audits or reviews.
- d. Monitor and critique the design and installation of financial and accounting systems and procedures, with emphasis upon the identification and use of valid audit trails and other management controls.
- e. Provide advice and review the use of quality control and other effectiveness indicators for financial management and resource use.
- f. Design and apply audit check lists for areas unique and/or critical to the local command.
- g. Review safeguards or refinements to existing controls for material and financial accountability.
- h. Review the proper execution of various directed programs.
- i. Review other problem areas, as directed.
- j. Render advice on matters of organization and staffing within comptroller areas.
- k. Maintain liaison with and provide assistance to external audit, inspection and/or review groups.

Regarding the actual conduct of internal review and also its follow-up role, Enclosures (3) and (4) to SECNAVINST 7510.8 provide the following salient points:

- a. Internal reviews should be conducted in a manner that will minimize disruption to normal operations.
- b. Internal reviews should be comprehensive assessments and evaluations supported by appropriate documentation.

c. An initial meeting with operating officials should be held prior to beginning a review, with the objective of explaining the purpose, scope, and estimated duration of the review.

d. Responsible officials and operating personnel should be kept fully informed during the course of a review and should normally be given the opportunity to comment on findings as they are developed.

e. The scope of a review should include a determination of:

1. compliance with established policies and procedures,
2. the reliability of records and reports,
3. the validity of supporting documentation affecting known or suspected problems, and
4. the effectiveness of the operations reviewed.

f. Statistical sampling techniques should be used where possible, in order to both improve the quality of internal reviews and reduce the workload impact upon operating personnel.

g. An exit conference should be held with responsible operating officials to discuss findings and the report content.

h. The comments of responsible operating officials during the course of the review and at the exit conference should be considered in preparing the report.

i. The internal review documentation should include the preparation of working papers which clearly indicate not only the subject areas reviewed but also the purpose, scope, source of data, reviewer, and conclusions of the review.

j. Line management should be given the opportunity to review the facts to be presented in the report for completeness and accuracy.

k. All internal review reports should be submitted to the commanding officer via the intermediate managers (if any).

l. Each approved audit or resource-related inspection recommendation requiring corrective action should be identified for subsequent follow up.

m. The follow up should be continued until all recommended actions are completed.

n. The follow up should determine the extent and effectiveness of corrective actions.

o. Records should be maintained to document follow-up action.

p. The liaison and follow-up responsibilities of the internal review function also include all actions and command correspondence related to external audits and resource-related reviews.

q. Care should be exercised to insure that the internal review function does not become one where record-keeping and monitoring subvert the primary purpose of reviewing command operations.

Regarding the overall work ethic of the internal review function, SECNAVINST 7510.8 provides the following guidance:

a. The planning and programming of internal reviews should be subject to periodic (e.g. semiannual) command review and approved insofar as practicable. [10:2]

b. Flexible scheduling is necessary to permit special reviews that are responsive to changing circumstances. [10:2]

c. Internal review should complement but not intentionally duplicate the responsibilities of centralized audit organization. [10:2]

d. The reviews performed should be conducted in such an independent, thorough, detailed, and professional manner as to minimize the necessity for duplicative reviews by external audit organizations. [10:2]

e. The internal review function should, as a first priority, always serve command. [10:2]

f. The follow-up program is an important element of internal review; however, the primary responsibility for implementing approved recommendations of internal review or external audit rests with line management. [10:2]

In summarizing their findings on internal review in the USN for purposes of a conclusion, the NAVAUDSVC stated:

"The policies outlined in SECNAVINST 7510.8 are only being partially accomplished. Many Naval activities have not established an internal review program and many of those that have, limit the scope of the internal review staff to areas not directly related to mission accomplishment." [36:3]

To support this conclusion, the NAVAUDSVC report contains four attachments referred to in the body of the report as: "typical findings written during these reviews (of 142 Naval activities)." [36:3] Prior to briefly paraphrasing these "typical findings" as further illustrations of the status of internal review in the USN, the significance of the term "typical" must be established. Webster defines the word "typical" as: "combining or exhibiting the essential characteristics of a group." [23:1266] Therefore, the following characterizations were chosen by the NAVAUDSVC to be representative of the USN's internal review program as a whole and in general. Only the salient points are presented here as the reader has previously been provided with discussions on the possible results of ineffective internal review.

- a. "NAS (Naval Air Station) does not have an operational internal review function." [36:A-1]
- b. "NAS had previously requested that an internal review billet be established, but CNAVRES (Chief of Naval Reserve), because of resource limitations declined the request." [36:A-1]
- c. "Our (NAVAUDSVC's) review disclosed vulnerable (to fraud and abuse) operational areas that are not being periodically reviewed." [36:B-1]
- d. "The activity's internal review function is almost exclusively limited to auditing non-appropriated funds and performing fund reconciliations. Audit boards are available to assist in reviews of non-appropriated activities but are not fully utilized." [36:C-1]
- e. "Local instructions list personnel required to assist internal review in the audits of non-appropriated funds. However, we (NAVAUDSVC) have been informed that they are not being used." [36:C-1]
- f. "During our (NAVAUDSVC's) review we also noted that internal review workpapers were incomplete and disorganized. Workpapers were not indexed and did not clearly indicate the subject reviewed, sources, purpose, scope, and conclusions." [36:C-1]
- g. "The NAVAUDSVC has developed an internal review training plan which outlines training courses that should be taken by internal review personnel in order to successfully perform internal review functions. A review of the training files of internal review personnel revealed that training in these areas has not been received." [36:C-1]
- h. "We (NAVAUDSVC) believe that management needs to improve its attitude toward Internal Review operations. We reviewed nine audit reports . . . and found that no responses were received for three reports and the response time ranged from 1 to almost 5 months for the other six reports. During our recent audits of other functional areas we identified some of the same deficiencies that have previously been identified by Internal Review. If management had been receptive to Internal Review's recommendations, we believe these deficiencies could have been corrected." [36:D-1]

i. "The overall effectiveness of the Internal Review Division has been hampered by a lack of continuity in leadership. Since its inception in 1972, Internal Review had had eight Military Directors whose tenures have averaged only 9 months." [36:D-1]

j. "Internal Review personnel lack the training to equip themselves to adequately perform reviews of certain functional areas, such as, appropriation accounting, non-appropriated funds, procurement, supply, etc. Furthermore, no formal training plans have been formulated for the Internal Review Division." [36:D-1]

k. "We (NAVAUDSVC) noted deficiencies in accounting for audit man-hours, controlling audits, and audit planning." [36:D-2]

l. "Internal Review does not perform pre-audit surveys of functional areas, as a result, man-hours are not expended wisely." [36:D-2]

m. "In many cases, working papers were inadequate, randomly placed in review folders, and difficult to understand without supplementary explanations from the preparer." [36:D-3]

n. "Although some effort has been initiated in audit follow up, adequate procedures have not been implemented to ensure that corrective action is taken on internal and external audit recommendations." [36:D-3]

o. "We (NAVAUDSVC) believe that one of the primary problems in Internal Review is that the auditors feel that management is not responsive to their recommendations, therefore, 'why bother'." [36:D-3]

5. Summary

In summary, this section has provided the reader with the existing guidelines concerning the work of internal review in the USN. These guidelines cover not only the functions to be performed by internal review but

also the actual conduct of a review, the follow-up role to be performed, and the overall work ethic of the internal review function.

The reader has been provided "typical" audit findings by the NAVAUDSVC in support of their stated conclusion that internal review in the USN is only partially accomplishing the established policies. These "typical" findings have illuminated deficiencies in such areas as existence, staffing, training, audit coverage, audit control and documentation, follow-up action, motivation, and command support. In short, deficiencies have been identified in almost every area which bears on the effectiveness of internal review in the USN.

The reader may now conclude that, since (a) effectiveness is the relationship between an organization's output (work performance) and its established policies and goals [8:5], and since (b) the NAVAUDSVC has shown that internal review in the USN is only partially accomplishing its policies and goals [36:3]; internal review in the USN may be properly described as ineffective.

G. SUMMARY

This chapter has provided the reader with evidential matter concerning the status of internal review in the DOD.

The reader has been exposed to the differing organizations, staffing levels, and performance policies

extant in the DOD. The chapter has discussed the diversity of internal review organizational structures and locations, which range from the totally centralized CAP of the DAF, through the decentralized but hierarchical internal review structure of the DA, to the totally decentralized structure of internal review in the DON.

The reader has been provided staffing data concerning internal review in the DOD; and has been shown the widely differing staffing levels which exist. These staffing levels, presented in Figure III-2, range from the 1,108 internal review personnel in the DA, through the 547 DON internal review personnel, to the 53 man-years actually expended by the DAF.

The performance policies prescribed by the various departments have been shown to vary from the broad mandates of the DA and DON to the somewhat limited nature of the DAF's CAP.

The actual work performance of the various internal review functions has been shown to be deficient in many areas; to the extent of being described by several reviewing bodies as ineffective. These deficiencies include deficiencies in scope, staffing, training, audit coverate, follow-up action, and command support among others.

Conversely, both the role and perceived importance of the internal review function have been shown to be

increasing in the eyes of DOD financial managers at the highest echelons and departmental levels. This situation, in the author's opinion, demands a total and complete strategical rethink of the internal review function; from its goals and objectives, to its staffing levels and work performance. This view was also expounded by The Task Force, which provided 38 recommendations for the improvement of audit, inspection and investigative components of the DOD. [37:Encl. 1]

As the author perceives it, DOD's situation regarding internal review is similar to a Board of Directors or a Chief Executive Officer in the private sector examining a facet of their organization which is not productive or not measuring up to its potential. Under the glaring scrutiny of the profit measure, these responsible managers must first review and reaffirm strategic plans such as: - "deciding on the goals of the organization and on the broad strategies that are to be used in attaining these goals;" [8:2] before deciding the management and operational controls to be implemented.

Translating this analogy into the DOD's situation, those responsible for establishing policy must first re-examine the essence and essential purpose of internal review and determine whether or not to continue; and if so, in what mode. From the comments of DOD policy makers such as the one by RADM Frost provided earlier, it appears that just such a re-evaluation has been performed, with the

outcome being a decision to continue. The next step in the analogy then, is to determine the various management and operational controls to be implemented and enforced. These controls are such things as the "rules, procedures, forms and other devices that govern the performance of specific tasks;" [8:2] and "The process by which management assures that the organization carries out its strategies effectively and efficiently." [8:3] These controls then, involve the organizational structure and location of the internal review function as well as its scope, staffing, training, and work performance guidelines.

As both a final summary of this chapter and as a prelude to the next chapter's analysis of several alternative methods for providing the controls cited above, the reader is asked to recall the "internal review balance sheet" introduced at the beginning of this chapter. Through the application of this tool, the reader can make a subjective determination of the effectiveness of internal review in each of the uniformed services; and also gain insight into the alternatives presented in the next chapter.

It should be re-emphasized at this point, that the determinations are subjective in nature and macro in scope. Much of the ranking relies on the reader's intuition, even when the conclusion appears to be obvious and has been supported by the studies and reviews of other investigative bodies.

The characteristics of internal review discussed in Chapter II on page 53 form the basis for comparison of the various department's programs; and the categories of sufficient number of personnel assigned, and overall work performance have been added.

The rating method is simple and direct; but as pointed out above, intuitive. Each department's internal review program was restudied; and based on the previous discussions a rating of -1, 0, or +1 was given using the following criteria:

1. Asset - a numerical score of +1 was given if the characteristic was definitely extant in the subject program. For example, a decentralized function is more responsive to local command than a centralized one. This is intuitively obvious, even if the section on internal review in the DAF had not provided evidence to show the DAF's CAP was not responsive.
2. Liability - a numerical score of -1 was given if the characteristic was definitely not extant in the subject program. For example, a decentralized function organizationally placed subordinate to the local comptroller is decidedly less independent in appearance, if not in fact, than a centralized function. Again, this is intuitive even if the section on internal review in the USMC had not provided evidence of this perception.
3. Zero balance - a numerical score of 0 was given if the characteristic was ambivalent, or if mitigating circumstances existed. For example, the decentralized nature of internal review in the DA gives a perception of non-independence; but its hierarchical structure provides a counteracting perception of independence which mitigates or "zeros-out" the "account."

For the purposes of this comparison, each characteristic was assumed to be of equal importance. Accordingly, the numerical scores were simply summed and averaged to provide a composite measure of the "effectiveness account" balance in the equation: $ASSETS - LIABILITIES = EFFECTIVENESS$. This composite measure of effectiveness has a possible range of -1 to +1; which may be interpreted as ranging from ineffective (-1) to effective (+1). In between these two scalar values, lies an area probably best described in the vernacular as gray. If the author may be permitted a pun on Naval jargon, haze gray is not squared away, at least in this instance.

Although not empiracally based or truly comparable to regression analysis, a general rule of thumb may be borrowed to interpret the gray area between the scalar minimum and maximum. The composite measure derived above is actually a percentage measure of the scalar distance from the benchmark of 0 to the numerical score obtained by the particular program under review. This may be equated for purposes of interpretation to the statistical measure r^2 , which measures the percentage of variance in a dependent variable explained by a change in an independent variable. The general rule of thumb usually applied is that a value of 0.7 or more is significant. In other words, a score of 0.7 or more can be said to be either significantly effective or ineffective, depending on the mathematical sign of the measure.

As shown by Figure III-12, none of the internal review programs in the DOD should be considered significantly effective or ineffective. The DA's internal review program comes the closest to being rated as effective. The DAF's CAP is the lowest ranked; and the only program receiving a negative score. The DON's programs are ranked very close to the benchmark, indicating the sensitive nature of the ratings received by these programs. In other words, a negative shift in the rating of one or two characteristics would result in negative scores for these programs.

In the final analysis, it appears that none of the DOD's internal review programs are in fact effective. However, the DA's program appears to be the most effective subsequent to both the narrative evaluation and the subjective ranking.

The next chapter will provide the reader with several alternatives for the organization and conduct of internal review; and attempt to analyze them with the objective of recommending which method should be used in the DON.

CHARACTERISTIC	NUMERICAL SCORE			
	USA	USAF	USMC	USN
RESPONSIVE	+1	-1	+1	+1
READILY AVAILABLE	+1	-1	+1	+1
INDEPENDENT	0	+1	-1	-1
ANALYTICALLY SKILLED/TRAINING	+1	+1	-1	-1
UNDUPLICATIBLE	0	-1	0	0
FOCUS ON COMMAND'S PROBLEMS	+1	-1	+1	+1
ASSISTANCE WITHOUT ADVERTISING	0	-1	+1	+1
FLEXIBLE	+1	-1	+1	+1
STREAMLINES OTHER AUDIT EFFORT	0	+1	-1	-1
PROVIDES FOR CORPORATE KNOWLEDGE	+1	-1	0	+1
SOLUTION ORIENTED	+1	-1	+1	+1
SUFFICIENT STAFFING	0	-1	-1	-1
OVERALL WORK PERFORMANCE	0	+1	-1	-1
TOTAL	+7	-5	+1	+2
COMPOSITE EFFECTIVENESS MEASURE	.539	-.385	.077	.154
NUMERICAL RANKING	1	4	3	2

EFFECTIVENESS OF INTERNAL REVIEW
IN THE
DEPARTMENT OF DEFENSE

Figure III-12

IV. ANALYSIS OF CENTRALIZATION/DECENTRALIZATION

A. INTRODUCTION

The previous chapters have provided the reader with the historical development of auditing in general and of the internal review function in particular. The reader has been presented detailed background material on the establishment, objectives, and status of the internal review function in the Department of Defense (DOD).

It has been shown that the organization of the internal review function within the DOD varies from the totally centralized Commander's Audit Program (CAP) of the Department of the Air Force (DAF), to the decentralized but hierarchical internal review program of the Department of the Army (DA), to the totally decentralized internal review programs of the Department of the Navy (DON).

A subjective analysis of the status of the various DOD internal review programs has shown that while none were either significantly effective or ineffective, the DA program was rated the most effective; and the DAF program was rated the least effective.

It is the author's contention that, notwithstanding the incontrovertible requirements of proper training, sufficient staffing, personnel expertise, definition of and adherence to work performance guidelines, and other

so-called "hard" or "measurable" requirements, the pivotal factor for an effective internal review function in the DOD is proper organization, including the precise definition of all attendant relationships. Victor Z. Brink has summed up the pervasive nature of this factor by stating:

" . . . there is however, a central question: what priorities should be given to serving corporate management (local commanders) versus serving the board of directors (higher echelons)?" (emphasis added) [15:29]

The answer accorded this question, leads one to the type of organization necessary to yield the desired results.

In this chapter, the author will seek to answer the question posed above; and also provide the reader with an analysis of several alternative organizational schemes, with the objective of determining which scheme provides the best prospect for obtaining an effective internal review function in the DON.

B. PROBLEM

In a classical cost-benefit analysis, the problem statement is typically an interrogative expression of the choice to be made, such as "which weapon system should be acquired."

In this analysis, the problem statement may be stated: "how to obtain an effective internal review function in the DON?" This statement assumes that a strategic

decision concerning the internal review function has already been made. As shown in Chapter III, one may assume this to be the case from the remarks of high DON policy makers such as RADM Frost, SC, USN, acting Comptroller of the Navy (NAVCOMPT).

Therefore, given that an internal review function will exist, the objective of the analysis is to determine what is the best method of obtaining an "effective" internal review function.

C. ALTERNATIVES

Regarding the question posed in the introduction to this chapter, Victor Z. Brink has stated:

"There are various sets of arrangements (alternatives) which could, in some way, separate or integrate these priorities. Those alternative arrangements extend from solely serving corporate management (total decentralization) to solely serving the board (centralized audit function), with various intermediate combinations." [15:29]

"Between the two alternatives of exclusive service to corporate officers or the audit committee (board of directors) there is a spectrum of possibilities.

. . . primary responsibility to the corporate management with a defined secondary responsibility to the audit committee.

. . . primary responsibility to the audit committee and a defined secondary responsibility to corporate management.

. . . equal responsibility to the two users of audit services." [15:31]

For the purposes of this analysis, the alternatives to be considered are:

1. A totally decentralized function solely serving and reporting to the local commander.
2. A totally centralized function solely serving and reporting to higher level management.
3. A function primarily serving and reporting to the local commander, with some defined secondary responsibility to higher management.
4. A function primarily serving and reporting to higher management, with some defined secondary responsibility to the local commander.
5. A function with equal responsibility to both higher management and the local commander.

D. CRITERION OF CHOICE

The criterion to be used for deciding which alternative should be selected as best achieving the objective of the analysis, is one of maximum effectiveness.

This criterion was chosen because the need for an effective internal review function, as shown in previous chapters, is being increasingly recognized and given priority status in the DOD and the Federal Government in general.

The criterion of cost is considered by the analysis only when the implementation of a particular alternative will tend to result in a duplication of the internal review function. This is done for two reasons. One, as alternative which results in a duplication of effort is

by definition not as efficient as one which achieves the objective without duplication; and two, as stated by NAVCOMPT: ". . . a good internal review staff will more than pay for itself." [30:2]

Therefore, in the first case, the alternative which results in a duplication of effort to achieve the same end is eliminated through inefficiency; and in the second case, the cost of the alternative is assumed to be irrelevant.

E. EFFECTIVENESS

Effectiveness has been previously defined in this thesis as the relationship between the outputs of an organization and the goals or objectives of that organization. In the private sector, the profit measure is a classical example. Assuming that the organization is not a non-profit one, the profit measure is a concise indicator of the effectiveness of the organization's operations. Although the private sector organization may have other, additional goals such as increasing existing market share or developing new products for new markets, the so-called "bottom line" is profit.

Unfortunately, no such concise measure exists for determining the effectiveness of an internal review function. This problem is not unique to internal review; and literally books have been written on the subject of measuring the effectiveness of organizations in which

either or both the outputs or objectives cannot be accurately or objectively measured. One such book by Anthony and Herzlinger, entitled Management Control in Nonprofit Organizations [8] is recommended by the author and forms the basis for much of this section.

In order to measure the effectiveness of an internal review function, one must resort to surrogate measures. Anthony has defined surrogate measures in a circuitous fashion by stating:

"In the ideal situation, the objective is stated in measurable terms, and the output measure is stated in these same terms. When this relationship is not feasible, as is often the case, the output measure represents the closest feasible way of measuring the accomplishment of an objective that cannot itself be expressed quantitatively. Such a measure is called a "surrogate" or a "proxy." [8:232]

One must be careful in the use of surrogate measures. Anthony has stated that if the lack of correspondence between the objective and the surrogate is not recognized, the organization may focus too much attention on the surrogate. [8:250] This dysfunction may even extend to the point where achieving the surrogate becomes more important than achieving the objective. [8:250] Anthony continues the discussion of surrogates by providing four examples of organizations which invested the means of achieving an objective with the end of actually achieving the objective. [8:250, 251] It is interesting, for purposes of this thesis, to note that all four examples are of governmental agencies or programs.

The surrogate measures of effectiveness to be used by the analysis will basically be the characteristics of effective internal review described in Chapter II. The assumption being, that if an alternative exhibits those characteristics, it will tend to be effective rather than ineffective; especially when contrasted to another alternative which does not exhibit those characteristics.

At this point in the discussion, the reader may well be pondering the thought of "what about the operative requirements such as staffing, training, or performance guidelines?" As stated previously, these requirements are incontrovertible. The answer however, is in the question itself. These are operative requirements, necessary for the internal review function to achieve its objectives once in operation. Without the proper staffing, training, etc., there is obviously little prospect for an internal review function to be effective in whatever form. In researching material for this thesis, the conclusions of various studies echoed each other in stating that staffing was insufficient and/or poorly trained; and that work performance was inadequate. Likewise, the recommendations usually counselled increased staffing, more training, and the observance of established guidelines. The organization of an internal review function does not alter these requirements. However, as exemplified by the DAF's CAP, the organization of an internal review function does have a

direct bearing on its use, or nonuse by the local commander. In the author's opinion the point to be made is that to be effective, the internal review function must first be employed. Only then, do the requirements of staffing, training, etc. become relevant to the analysis. Perhaps a good summary is a colloquial one from the game of poker: "You can't win if you aren't in; but you surely can lose your ante."

Therefore, the analysis will concentrate on the characteristics previously listed; and attempt to measure each alternatives' propensity for exhibiting each alternative.

The system of measurement will be that employed in Chapter III. A numerical score of -1, 0 or +1 will be assigned to each characteristic for each alternative. The alternative receiving the highest positive total score will be judged to be the alternative best capable of obtaining an effective internal review function, in concert with the operative requirements previously discussed in this section and in Chapter III.

F. EVALUATION OF ALTERNATIVES

1. First Order Analysis

The first step in the evaluation, is to seek any alternative which may be dismissed for obvious reasons. Therefore, the alternatives will first be reviewed briefly

to see if such a condition exists. The brief analysis provided for each alternative is that of Victor Z. Brink, a charter member of the Institute of Internal Auditors (IIA); and a recognized authority in the field of internal auditing. Dr. Brink's remarks are slightly paraphrased from his article in the December, 1978 issue of The Internal Auditor, entitled: "Internal Auditing: A Historical Perspective and Future Directions." [15]

a. Alternative 1

A totally decentralized function solely serving and reporting to the local commander.

The merit of this arrangement is that the local commander can use the internal review group to fully serve his or her own managerial needs - free from outside restrictions. Under such conditions, internal review's emphasis would be primarily on operational auditing plus whatever financial auditing activities local management believes it needs to discharge its responsibilities to higher authority or are required by higher authority.

However, higher authority would, presumably, have to make greater use of the centralized internal audit function to care for their needs or, alternatively, create a new audit group (a higher echelon internal review function?) to provide some of the needed services.

Since nothing in the analysis above is obviously errant, Alternative 1 will be carried forward

b. Alternative 2

A totally centralized function solely serving and reporting to higher level management

Under this alternative, the internal review group would primarily protect the responsibilities of the higher authority and would concentrate on the traditional functions of compliance, protection, and integrity.

Under this arrangement however, the role of the internal reviewer would more closely approximate that of the external auditor. There might also be conflict between the work of internal reviewers and the operating organization because internal reviewers, to a considerable extent, would be checking on local management for higher authority.

Presumably, internal reviewers would take on a more powerful protective role. In so doing, they could directly or indirectly undermine, or even give up, a major stake in operational auditing. It is also likely - if not inevitable - that local management would seek to obtain operational auditing services from another organizational component or that it would create an entirely new group to do in-house operational audits.

The reader will recall from the discussion of the DAF's CAP, that this duplication of effort is actually taking place in the DAF.

Accordingly, this alternative is dismissed for reasons of inefficiency and duplication of effort as defined in the criterion for choice.

c. Alternative 3

A function primarily serving and reporting to the local commanders, with some defined secondary responsibility to higher level management.

Under this alternative, the role of internal review to local management would stay much the same as in Alternative 1. The dotted-line responsibility to higher level management would, presumable, include periodic reporting - both in writing and in person - and immediate communication between parties as deemed necessary.

The stated responsibilities would probably define particular levels of required disclosure.

The advantages are that each interested party might be able to get everything it needed in the way of services without restricting the control required by local management for achieving effective operations.

The disadvantages are that there might still be some conflict of interest between management and higher authority and that higher authority might feel that it was not getting enough protection from the internal review group to satisfy its expanding needs.

Since nothing in the analysis above is obviously errant, Alternative 3 will be carried forward.

d. Alternative 4

A function primarily serving and reporting to higher management, with some defined secondary responsibility to the local commander.

Under this alternative, the higher level management would be in top control. This alternative more fully satisfies governmental pressures for strong safeguards. It would, however, have the disadvantage of tending to restrict local management in its use of internal reviewers in areas of operational auditing. There could also be some hostility generated between local management and higher authority. The benefits to internal reviewers would be that they would retain ties with both groups. At the same time, it would pose questions as to whether they could adequately discharge both audit roles. Again, local management might feel the need for a new audit group it could more effectively control.

Again, the reader will recall the DAF's CAP; and its support by example of the analysis presented above. Since this alternative differs only in degree from Alternative 2, it is also dismissed for reasons of inefficiency and duplication of effort as defined in the criterion of choice.

e. Alternative 5

A function with equal responsibility to both higher management and the local commander.

This alternative appears, on the surface, to be attractive because it asserts full service of internal reviewers to both parties of interest. The major problem here, however, is whether this organizational arrangement is sound or even realistic. Can an internal review group function under two administrators? Admittedly, there are some situations where this has been tried with reasonable success. The project team, with dual responsibilities of the member to the project manager and to the department from which he or she has been assigned, is one example. However, in such a situation, there is a higher level of organizational authority which is reasonably available to directly or indirectly resolve any major conflict. It is doubtful whether a higher-level arbiter exists between local management and higher authority, in any practical sense.

Even though the concept of equal joint responsibility may sound like a good solution, there is considerable doubt as to whether it is satisfactory for all parties, including internal reviewers.

Accordingly, this alternative is dismissed for the same reasons as alternatives 2 and 4.

f. Summary

The first order analysis has eliminated all but two alternatives from further consideration. The

reasons of inefficiency, duplication of effort, and practical unworkability are supported by evidence contained in the discussion of the DAF's CAP; and by the statements and opinions of Victor Z. Brink. A summary of the tendencies of the three eliminated alternatives is provided by Dr. Brink in his article cited above:

"On balance, it appears - at least to me - that . . . (higher authority) cannot effectively take over the role of . . . (local management). If they do, they will need full-time people of the caliber of today's . . . (local commanders).

In such a situation, the present . . . (local commanders) would become . . . (higher managers) and simply have new titles. In that case however, we would need a new group to monitor . . . (higher authority) in discharging their greater operational responsibilities - a kind of superboard. Thus we would be back about where we started."

[15:32]

In addition to the "full circle" affect described by Dr. Brink above, other reasons have been expounded against the centralized approach to the internal review function. For example, The Task Force on Evaluation of Audit, Inspection and Investigative Components of the Department of Defense (Task Force) concluded that the DAF's CAP and a similar centralized approach proposed by a joint study group within the DOD "might increase the likelihood that the audit services available to local commanders will be undertaken by qualified and competent auditors." [11:139] However, The Task Force continued by stating: [11:139-145]

"In our opinion (The Task Force), however, these benefits (of centralization) would come at an unduly high price because the Air Force's Commander's Audit Program and the similar proposal advanced by the Joint Study Group would not fulfill important needs of local commanders for the following reasons:

1. Commanders would be forced to rely on other staff advisors for many of the services currently provided by internal review . . .
2. The internal audit components are increasingly providing less attention to the audit needs of local commanders . . .
3. The trend away from the local commander's audit concerns would not be reversed by merging internal review and internal audit . . .
4. The need for more financial audits would not be served by the proposal . . .
5. Commanders would be reluctant to request local audit assistance from internal audit organizations.

As a final argument in support of dismissing the centralization alternatives, the author offers that the definition and intended purpose of the internal review - function previously provided to the reader are to provide audit and investigate capability to the local commander. A proposal to centralize the internal review function would in effect remove the direction and control of the function from the local commander and place them under some authority higher than the local commander. This would have the practical effect, in the author's opinion, of adding an additional oversight agency reporting on the local commander to some higher authority - at least from the

local commander's viewpoint. The logical practical outcome of such an action, would be the lowered utilization of such a centralized function by the local commander; as evidenced by the DAF's CAP, and the attendant comments by DAF local commanders which have been previously provided.

The Task Force referred to this characteristic as providing the local commander with "assistance without advertising his or her problems." The author chooses to express it in less academic but perhaps more graphic terms familiar to most military managers. It is simply the survival instinct; and a cardinal rule of survival is "not to put oneself on report."

Therefore, while the centralization alternatives obviously have merits, it is the author's opinion, as supported by The Task Force, that not only would centralization remove the internal review function from the direction and control of the local commander contrary to current definition; but also it would result in lowered usage of the formal function.

2. Second Order Analysis

The remaining two alternatives are actually differing degrees of decentralization. Alternative 1 proposes a totally decentralized internal review system, comparable to the current DON internal review function; and Alternative 3 proposes a modified version similar to the current DA internal review function.

In evaluating two similar alternatives, the first step is to eliminate those factors of the analysis which are, in effect, the same for both alternatives. The analysis can then concentrate on those evaluation factors which are different; and thus relevant to the analysis.

Accordingly, because of the decentralized organization of both alternatives, the evaluation factors of responsiveness, ready availability, unduplicatibility, focus on command's problems, flexibility, accumulation of corporate knowledge, and solution orientation were judged by the author to be approximately equal for both alternatives. This judgement was based on the definitions provided for these characteristics in Chapter II when viewed from a decentralized perspective.

The remaining evaluation factors of independence, analytical skill, assistance without advertising, and streamlining of other audit work are discussed below.

a. Independence

As previously stated, the appearance of independence is viewed by the auditing profession as being as equally important as actual independence. From this standpoint, it is obvious that an internal review function organizationally located subordinate to a local commander will not appear to outside observers as independent. This

statement is supported by Robert H. White, CIA, in his article "Can Government Auditors Be Independent?" Mr. White states:

"The presumption of independence is considerably weakened, in my view, in the employee - employer relationship and evidence sufficient to offset this loss would have to be available, in the case of government, to all government constituents."
[35:41]

In the case of Alternative 1, no such evidence is available to offset the perception of non-independence. In Alternative 3, the existence of clearly defined secondary responsibilities to higher authority including as Dr. Brink envisioned " periodic reporting" and "immediate communication between parties;" serves to mitigate to some extent the perception of non-independence. Accordingly, Alternative 1 is given a numerical score of -1; indicating the lack of apparent independence. Alternative 3 is given a numerical score of 0, indicating the mitigating effects of the secondary responsibilities to higher authority.

The numerical scores of each alternative will be displayed at the conclusion of the evaluation.

b. Analytical Skill

On the surface, the alternatives would not appear to differ on this factor. However, the secondary responsibilities to higher authority of Alternative 3 are assumed by the author to include professional guidance and technical oversight as exist in the DA's internal

review system. The existence of formal oversight by professional auditors as to the technical qualifications and development of internal review personnel in Alternative 3 as opposed to unenforced guidelines in Alternative 1; would tend to product more analytically skilled auditors in the long run. The Task Force found this to be the case when comparing internal review in the DA with internal review in the DON; and stated:

"Thus, unlike the Army, there is no requirement that naval internal review personnel possess any audit-related background or that they comply with auditing standards in the performance of their duties." [11:128]

Therefore, Alternative 1 is given a numerical score of -1; based on the historical evidence which indicates the tendency of a totally decentralized function, unsupervised by other professionals, to neglect the requisites of professional status and analytical training.

Alternative 3 is given a numerical score of +1 for this factor. This is also based on the historical data presented by The Task Force, which indicates that the modified decentralized function does tend to better recognize and provide for professional and analytical skill. [11:135]

c. Assistance Without Advertising

For this factor, the totally decentralized function tends to offer a better opportunity than does the modified function with secondary responsibility to

higher authority. From the discussion at the end of the first evaluation section, this should be obvious to the reader. A function totally under the direction and control of a local commander is obviously less apt to "advertise," than is one which has formal direct communication to higher authority including periodic reporting.

The reader is reminded of the discussion of this characteristic in Chapter II, which cautioned against the interpretation of this characteristic in the context of a "cover up." That discussion stated that one should construe the meaning as providing the local commander the ability to identify and correct problem areas without being subjected to additional scrutiny and criticism.

Therefore, Alternative 1 is given a numerical score of +1 for this factor. A numerical score of 0 is given to Alternative 3 because, although the tendency to "advertise" is greater, the function is still under the direction and control of the local commander. Also, it is assumed that some sort of guidelines such as those extant in the DA's internal review program, would exist, detailing the "mandatory" disclosures; and that the local commander would exercise control over all others.

d. Streamlines Other Audit Effort

The rating for this factor is in reality a function of the factors of independence and analytical

skill. The definition of this factor refers to the ability of other auditors to "build on" the work of the internal review function, rather than duplicate it. This "building on," cannot be accomplished until the other auditors are first satisfied as to the extent and reliability of the work of the internal review function. Since the characteristics of independence and analytical skill, when positive in nature, tend to support the reliability of the internal review function's findings, and the depth of the analysis used to discover and support those findings; it is logical to assume that the alternative exhibiting these two factors the strongest would also tend to better streamline other audit effort. A review of these two evaluation factors, reveals that Alternative 1 received a cumulative score of -2; and that Alternative 3 received a total score of +1.

Accordingly, Alternative 1 is given a numerical score of -1 for this evaluation factor. This stands to reason, because neither of the other two ratings contribute in a positive manner to providing confidence in the internal review function to an outside auditor.

Alternative 3 is given a numerical rating of 0, because the positive nature of the analytical skill factor offsets or mitigates the ambivalent appearance of independence. These, in the author's opinion, combine to produce an atmosphere in which an outside auditor would be more confident of the reliability and extent of the

internal review effort, than the same auditor would be of the internal review effort of the totally decentralized function.

e. Summary

The second cut has shown the two alternatives to be approximately equal in seven of the eleven evaluation factors, due to the decentralized nature of both alternatives.

In the other four evaluation factors, the alternatives were rated as follows:

	<u>Alternative 1</u>	<u>Alternative 3</u>
Independence	-1	0
Analytical Skill	-1	+1
Assistance without advertising	+1	0
Streamline other audit effort	<u>-1</u>	<u>0</u>
TOTAL	-2	+1

G. SUMMARY

Based on the measure of effectiveness and criterion of choice defined in this chapter, the results of the analysis indicate that Alternative 3 offers the best prospect for obtaining an effective internal review function.

This indication was derived by an analysis conducted in the style of a typical cost/benefit analysis. The author first presented the contention which led to the

analysis; and then provided the reader with the problem statement and objective of the analysis. The five alternatives to be evaluated were identified; and the criterion of choice defined and explained. The use of surrogate measures for effectiveness was discussed; and the evaluation factors to be used in the analysis were identified.

The author explained why such measures as sufficient staffing, proper training, etc., were not considered by the analysis. The method of evaluation was defined; and the basis for decision established.

The analysis itself consisted of two parts, a "first-order analysis" and a "second-order analysis." In the first-order analysis, the objective was to eliminate any alternative which could be eliminated based on obvious reasons. Using a brief analysis performed by Victor Z. Brink as evidence, the first cut resulted in the elimination of three "centralization" alternatives.

The second-order analysis of the analysis concentrated on four evaluation criteria, since the other seven factors were judged to be approximately equal for both alternatives.

The outcome of the second-order analysis indicates, as stated earlier, that Alternative 3 - a function primarily serving and reporting to the local commander, with some

defined secondary responsibility to higher management - offers the best prospect for obtaining an effective internal review function, when performed in concert with the operative requirements of staffing, training, etc.

The next chapter will further discuss the alternative selected; and attempt to define the "secondary responsibility to higher management." Lastly, the chapter will provide recommendations for implementing the alternative selected, in the DON.

V. CONCLUSIONS AND RECOMMENDATIONS

A. INTRODUCTION

The stated purpose of this thesis was to determine the best method of accomplishing internal review in the U.S. Navy (USN). The objectives established in Chapter I to achieve this purpose were to:

1. Determine the degree of compliance with current directives and preferred practices in the USN.
2. Determine the underlying causes of non-compliance.
3. Examine alternatives to improve the effectiveness of internal review.
4. Make recommendations as to which alternative offers the best probability of increasing the effectiveness of internal review in the USN.

In accomplishing these objectives, Chapter III provided the current status of the internal review function in each of the four military components of the Department of Defense (DOD). Chapter III identified deficiencies in the scope, staffing, training, audit coverage, follow-up action, command support, and other areas of the various DOD internal review functions.

Chapter III also presented the findings and opinions of The Task Force and the Naval Audit Service (NAVAUDSVC) as to the reasons for non-compliance with current directives. One such opinion by the NAVAUDSVC, was that some local

commanders decided that the resources required to expand or establish an internal review function were not justified, possibly due to a lack of understanding or appreciation of the benefits of an effective internal review program [36:3]

Chapter IV defined five alternative organizational structures for the internal review function, and conducted an analysis of those alternatives using the classical cost-benefit analysis as a model. The method of evaluation was the "internal review balance sheet" developed in Chapter III; and the analysis consisted of two stages - a first-order analysis which sought out any obvious reasons for dismissing an alternative, and a second-order analysis which concentrated on the relevant differences of the remaining alternatives.

The effect of the preceding four chapters was to indicate an organizational structure which, when combined with the operative requirements of sufficient staffing, training, etc., offers the best prospects for obtaining an effective internal review function in the DON.

This chapter will elaborate on the alternative selected by discussing the pros and cons of centralization/decentralization, and be redefining the selected alternative in greater detail. Lastly, this chapter will provide recommendations for defining and implementing the chosen alternative in the DON.

B. GENERAL

The analysis conducted in the previous chapter indicated that a decentralized but hierarchical internal review organization structure offers the best prospect for obtaining an effective internal review function.

The specific organizational alternative chosen by the analysis defined internal review as: "a function primarily serving and reporting to the local commander, with some defined secondary responsibility to higher management."

This definition is compatible with the concept of internal review as expressed by the Comptroller of the Navy (NAVCOMPT) when he stated:

"Internal review is a function performed within a command, at the direction of the head of that command or in pursuance of a plan approved by him, the results of which are reported to him." [22:2-2]

However, the alternative chosen by the analysis recognizes that some facets of the internal review function such as independence, analytical skill, and streamlining other audit work do benefit from some degree of centralization.

The question of centralizing or decentralizing an organization or organization function, is one that has been pursued in numerous articles and books on the subject of management. Ross A. Webber offers some insight into the discussion, in his text on management entitled: Management: Basic Elements of Managing Organizations. [38]

Mr. Webber states:

"Centralization is not like a disease you either have or do not have. The range from centralization to decentralization is a continuum, not an either/or dichotomy . . .

Theoretically, a perfectly centralized organization would have one authoratative person at the very top who would be all-knowing and perfectly wise. Therefore, that person could make all the important decisions. The resulting organizational performance would be exactly the same as with a completely decentralized organization in which each lowest level manager is perfectly knowledgeable and wise about his or her area of responsibility. Thus there is not theoretical advantage to either centralization or decentralization; it depends on those deceptively simple terms 'knowledgeable' and 'wise'." [38:378]

Mr. Webber further states that:

"The degree of centralization depends on the particular organization, its situation, and its managerial capacities. Each must work out a location along the centralization/decentralization continuum that best suits its needs." [38:379]

In summarizing the centralization/decentralization debate, Mr. Webber offers the following arguments advanced in support of both alternatives: [38:379]

1. Arguments advanced in support of centralization:

a. "Brilliant, energetic, and knowledgeable people are rare, Therefore, it is appropriate to concentrate authority in them."

b. "Whether small or large, organizations require coordination and integration of their various activities. This is best accomplished by a centralized authority who can see overall needs."

c. "In a fairly sizable and diversified organization, different functional and operating managers will come to think differently and to focus on their own units, perhaps exaggerating their importance to the whole (suboptimization).

From time to time, overall organizational interest will require unpopular decisions that most personnel will disagree with. Only a centralized management can make such decisions."

d. "Confidentiality of strategic plans and tactical decisions can be better maintained if restricted to a small group at the top."

2. Arguments advanced in support of decentralization:

a. "As an organization becomes larger and more complex, top management only deludes itself if it thinks that it can maintain central control. This is a physical impossibility. Since deteriorating control is inevitable, delegation should be conducted logically through decentralization."

b. "Decentralization lodges authority in the managers most knowledgeable about the specific details of their products, customers, and market conditions. Hence, their policies and procedures will be more appropriate than those set by centralized authorities."

c. "Decentralization will create organizational units small enough for managers to fully understand and identify with. If a manager is given sufficient authority, the organization can benefit from the same kind of commitment and motivation as that of the owner-manager."

d. "Pushing decision-making authority down the organization will provide more people with an opportunity to participate. General motivation and job satisfaction will be greater and management development more effective."

As a final aid to the determination of the extent of centralization or decentralization from which an organization may benefit, Webber offers the following questions for consideration in the decision process. The implications, as perceived by this author, follow each question parenthetically. [38:379]

1. "Who knows the facts on which decisions will be based?" (top management - centralize; lower management - decentralize)
2. "Who can get the information most readily?" (top management - centralize; lower management - decentralize)
3. "Who has the ability and knowledge to make sound decisions?" (top management - centralize; lower management - decentralize)
4. "Must speedy decisions be made to meet local conditions?" (no - centralize; yes - decentralize)
5. "Must local decisions be carefully coordinated with other activities, or are local units fairly independent?" (coordination required - centralize; independent - decentralize)
6. "How busy are top-level executives? Who has the time to plan versus making operating decisions?" (top management has the time to plan - centralize; lower management has the time - decentralize)
7. "Will initiative and morale be improved by decentralization? Will this help the organization?" (self-explanatory)

The foregoing discussion of centralization/decentralization was presented in order to provide the reader with some basic facts from which to judge the subsequent discussions and recommendations.

The next sections will further amplify the alternative chosen in the analysis; and provide some recommendations for its implementation in the Department of the Navy (DCN).

C. AMPLIFICATION OF ALTERNATIVE

The alternative selected by the analysis, bears a close resemblance to the system currently in operation in the Department of the Army (DA). Accordingly, the DA's internal review system can serve as a model for designing an internal review system for the DON.

1. Local Organization and Staffing

As shown by the data presented in Chapter III, the DA's internal review functions are for the most part organizationally located under the local comptroller. Likewise, the majority of DON internal review components are also organized under the local comptroller.

In the interest of providing a greater appearance of independence, ensuring direct communication, and enhancing responsiveness and flexibility; it is the author's opinion that the internal review function should be organizationally located in a direct staff relationship to the local commanding officer. The local comptroller, as the command's designated financial manager, should have advisory capacities both to the local commander and to the internal review function. This would provide an additional source of knowledge and informed opinion, to both the local commander and to the head of the internal review function.

The Task Force made a similar recommendation which was concurred with by the DON:

"The local commander should personally direct the application of internal review resources, and the distribution of internal review reports should be left solely to the commander." [37:Encl.1]

The Task Force also recommended that the internal review function's staffing level be kept small enough to provide only a portion of the local commander's cyclic audit needs, in order to remain a supplement to, rather than a substitute for the internal audit function.

[37:Encl.1]

The DON concurred with this recommendation, stating that the departmental level staff office, when established, should define the policy. [37:Encl.1]

In the author's opinion, the size of the internal review function should be such, as to allow the accomplishment or oversight of all required audits such as civilian timekeeping or non-appropriated fund audits; and leave approximately 50 percent of the available man-hours open for locally originated reviews.

At first glance this may appear excessive. However, the author supports the continued use of the local audit board concept as defined in Chapter III; as does the DON. [37:Encl.1] The revision proposed by the author, is in the organization and use of the local audit boards. The author proposes that the local internal review function be formally delegated oversight authority and focal point responsibility for all such boards by the

local commander. This would have the effect, in the author's opinion, of strengthening the local audit boards by placing a professional auditor with full authority in a management position. Also, it would relieve the local commander of some administrative tasks. In addition, there would then exist a single entity within the organization (excluding the local commander, of course) with cognizance of and control over all audit/review functions. This would facilitate both internal and external communications in the author's opinion; while not degrading, and possibly even enhancing the effectiveness and independence of the audit boards, because of the independent organizational location of the internal review function.

In other words, the multitude of local audit boards, would be centralized under an independent "internal review manager," who would report directly to the local commander. These audit boards would continue to be staffed by ad hoc/collateral duty personnel as they are at present; but in the author's proposal they would be coordinated by the internal review function.

By using these audit boards to the maximum extent, the internal review function could accomplish most "required" audit work through the use of trained and properly supervised temporary personnel. The system

proposed, is analogous to the common practice in private sector auditing where a partner in an accounting firm is assigned oversight responsibilities for a number of audits at the same time. The partner manages an individual audit through consultations with what would be the senior member of the local audit board in the DON. Thus the partner is able to supervise and provide guidance and knowledge, without actually performing the work. This concept allows one experienced professional to manage many individual audits.

However, the analogy does differ in at least one important aspect. The "junior" auditors of a private sector firm are employed as full-time professional auditors in their own right, and are thus professionally motivated for obvious reasons such as career advancement. On the other hand, the personnel assigned on a collateral duty basis to local DON audit boards are normally professionally oriented and evaluated for career advancement in fields other than auditing.

While some of these personnel may be engaged in related fields such as fiscal management, the majority are professionally oriented and evaluated in such non-related fields as engineering or aviation. The logical tendency is an audit board member who is motivated toward his or her own professional area and not toward the collateral

assignment on a particular audit board. The logical end result is unmotivated audit board personnel who view the assignment as both undesired and undesirable; and who tend to perform such a duty accordingly.

The logical net effect to the "internal review manager" is an increased requirement to personally supervise the planning and conduct of a particular audit, when compared to a "partner" in the private sector.

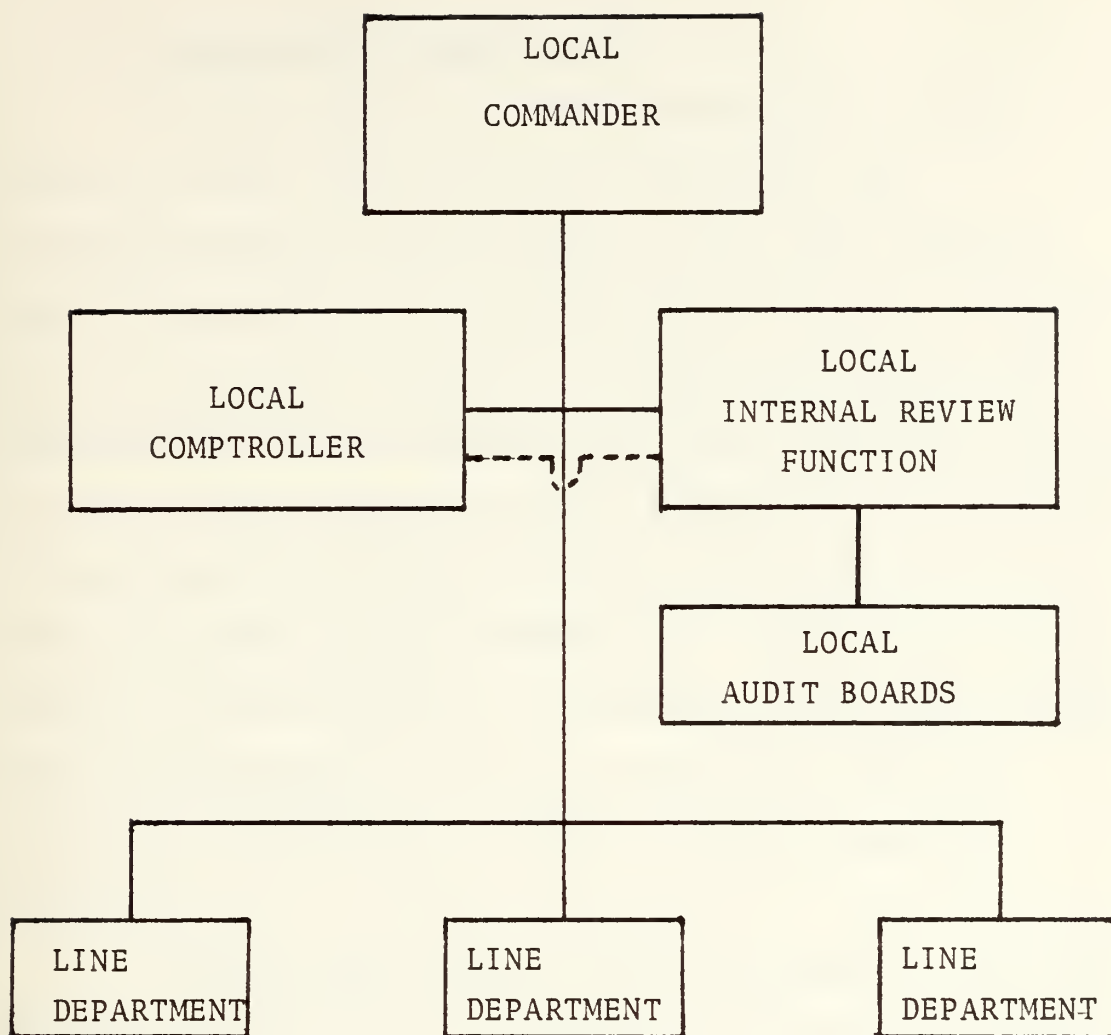
In the author's opinion, the point to be made is that while organizing the local audit boards under the internal review function will not eliminate the basic motivation/performance problem discussed above, it will provide the direct professional supervision and guidance now lacking which would tend to improve the quality of such audits.

In addition, the number of personnel assigned to the internal review staff should not have to be increased on a one-for-one basis when assigned the task of managing the local audit boards. Although each local command would be somewhat unique, an estimate could be made regarding the number of man-hours necessary to properly plan and supervise all "required" audits to be conducted by local audit boards. This man-hour estimate would vary between commands depending upon both the quality of internal review personnel, and the command support which is provided by properly staffing the local audit boards.

Added to the man-hours necessary for planning and supervising local audit boards, would be the number of man-hours necessary for the internal review staff themselves to conduct any additional "required" audits. This total "required" man-hours would serve as a base for computation of the man-hours to be devoted to locally originated reviews.

Using the proposal made above, the calculated man-hour figure would be doubled to determine the amount of staffing required to provide the local commander with an equal capacity for conducting both locally originated reviews, and reviews of local activities which are required by higher authority.

In summary, the author has proposed, based on conclusions drawn from Chapters III and IV, that the internal review function be organizationally located in a direct staff position to the local commander. In addition, the author has proposed to consolidate all existing local audit boards under the cognizance of the internal review function. In the author's opinion, this would strengthen the internal review function itself because of the probability for increased command attention; and also serve to streamline the work of the various local audit boards because of centralized management by a professional auditor. Figure V-1 illustrates these proposed organizational relationships.



PROPOSED ORGANIZATION
OF LOCAL
INTERNAL REVIEW FUNCTION

Figure V-1

2. Departmental Organization

Drawing upon the current organization of the internal review function within the DA and the recommendations of The Task Force; the author proposes that the internal review function in the DON be organized in a hierarchical structure. In order to preserve the independence of the internal audit function when conducting an audit of the internal review function, the hierarchical entities should not fall under the overall direction of the Naval Audit Service (NAVAUDSVC). Instead, the author concurs in The Task Force recommendation, as does the DON, that the hierarchical entities should fall under the purview of NAVCOMPT, as the DON's financial manager.

[38:Encl.1]

The Assistant Comptroller of the Navy (Financial Management System) has outlined the following as the proposed assignment of responsibilities for internal review in the DON: [39:1, 2]

a. NAVCOMPT functions

1. Career management for internal review personnel
2. Training course coordination
3. Doctrinal guidance (SECNAVINST 7510.8)
4. Development of staffing standards
5. Organizational placement guidance
6. Gathering of management control information

b. NAVAUDSVC functions

1. Audit of internal review programs
2. Development of specialized audit programs

The NAVCOMPT functions are proposed to be accomplished by establishing an internal review policy and oversight component within the Performance Analysis and Evaluation Division of NCFE-2/NAFC02. [39:1]

Regarding the implications of hierarchical organization as to the review of local commands by major commands, the DON has expressed reservations in extending the internal review function to permit major commands to perform multilocation audits at subordinate commands.

[38:Encl.1] The reason given, is that this practice would subject the subordinate commands to still another review of its operations by an external organization.

[38:Encl.1]

The author concurs in this reservation. The author proposes that the internal review functions of major commands limit their reviews of subordinate commands to reviews of the internal review function only; unless a review is requested by the local commander, or evidence emerges which indicates possible fraud or gross mismanagement of resources.

This proposal is not in fact original. A senior command has always had the prerogative of "inspecting" a

subordinate command. This prerogative is a function of the delegation of authority via the chain of command and the traditional Naval notion that a senior is ultimately responsible for a subordinate's actions. The use of an internal review group to perform such an "inspection," in the author's opinion, is a logical use of personnel resources. Unless specialized technical or operational knowledge requirements exist, a professional auditor should be able to conduct such a review more efficiently and effectively, with less disruption to local operations, than an ad hoc "inspector" not so qualified. In addition, the use of an internal review function to conduct such an "inspection" provides the senior commander a viable first alternative to requesting assistance from such agencies as the NAVAUDSVC or the Naval Investigative Service (NIS). This alternative provides the senior commander with the internal review characteristic of "assistance without advertising."

Therefore, in the author's opinion, the internal review function in the DON should be hierarchically organized with the higher echelons charged with the routine responsibility for overseeing the professional conduct of the lower echelons; much the same way as currently exists in the DA. The reader is referred at this point, to the discussion of the internal review

function in the DA which was presented in Chapter III. This discussion provided the salient points of the oversight responsibility of higher echelon internal review; and is not repeated here for the sake of brevity.

In summary, the author has proposed organizing the internal review function in the DON in a hierarchical manner along the existing structure of line authority. The departmental echelon would be located in NAVCOMPT; and would have the responsibilities listed above. The chain of command, so to speak, would flow downward according to the existing DON line hierarchy; with each echelon in turn being professionally guided and overseen by the echelon above, and professionally guiding and overseeing the echelon below. This professional guidance and oversight external to the command structure, if properly implemented, would serve in the author's opinion, to enhance the independence and professionalism of internal review without detracting from the local commander's prerogatives. It could also provide the local internal review function a "professional" chain from which to extract interpretations and guidance concerning various rules, regulations, procedures, and policies.

3. Definition of Secondary Responsibilities

As defined by the alternative chosen, the internal review function's primary responsibility is to the local

commander. However, some secondary responsibility is denoted to higher management. The extent of this secondary responsibility is, of course, a matter for the highest DON decision makers.

It is apparent from the remarks quoted earlier concerning the DON's reservation about adding an additional review of subordinate commands by an external organization, that the present inclination would be to limit the internal review function's secondary responsibility to higher management. The author concurs in this limitation, based on the remarks and usage data previously presented regarding the Department of the Air Force's (DAF) Commander's Audit Program (CAP); and on the basic definition of the internal review function.

In the author's opinion, the internal review function's secondary responsibilities should be limited to only those that are required to assist the local commander to ensure that the internal review function is performing its mission; or which provide basic management information data. The author concurs, as does the DON, with The Task Force recommendation that "The reports of the Department's (of Defense) internal review . . . components should not be included in the Department's (of Defense) proposed centralized 'follow-up' procedures."

[38:Encl.1]

The secondary responsibilities envisioned by the author would include such items as the approval of the local annual audit plan by the next higher echelon only so far as to ensure that all "required" audits are scheduled in a proper manner; and the routine reporting of basic personnel statistics such as positions authorized, positions filled, training planned and accomplished, etc.

The downward responsibilities from the higher echelons to the local internal review function would include the provision of guidance, the interpretation of policy, the provision of audit manual and audit program updates, the provision and explanation of new or existing audit procedures, the coordination and assistance with training requirements, etc.

In short, the requirements envisioned by the author are somewhat analagous to those existing in the financial management area; but perhaps not quite as extensive. For example, the local command's fiscal officer, by whatever title, is directly responsible to the local commander for the proper management and accounting of the command's funds. The fiscal officer is provided the policy, procedures, direction, and guidance necessary to accomplish his or task through a secondary chain of responsibility emanating downward from the departmental level of financial management. The local fiscal officer

therefore, is responsible not only to the local commander for managing the command's fiscal resources but also to the DON's higher financial managers. On the positive side, it is through this secondary or "professional" chain that the fiscal officer gains the training, expertise, and any additional guidance necessary to best discharge his or her responsibility to the local commander.

The secondary responsibilities of the internal review function then, would include the "professional" or "how to" aspects of internal review. Except for those audits required by higher authority, such as reviews of non-appropriated fund activities, the "what to audit" would be a primary responsibility the internal review function would discharge under the direction of the local commander. The "how to audit," would be a responsibility discharged under the purview of the secondary or "professional" chain. It should be obvious to the reader, that the better the secondary responsibility is discharged, the more benefits are to be gained by the local commander from the internal review function.

In summary, the author proposes that the definition of secondary responsibilities be one that is restricted to "professional" issues or management information data. The overall objective of these secondary responsibilities should be to assist the local commander by helping to

provide a well qualified, knowledgeable, and professionally competent internal review function; not to constitute an additional avenue of review and inspection of the local command by an external organization.

As the data presented in Chapter II showed, internal auditing as an individual component of management control, did not begin to truly develop until its practitioners gained independent, professional status. In the author's opinion, if the secondary responsibilities of the internal review function serve only to develop and promote the "professionalization" of internal review, then their objective will be accomplished; and the "professional motivation" thus instilled will provide the local commander with a competent internal review function without the need for additional external scrutiny of the local command.

D. IMPLEMENTATION IN THE DON

In their report on the status of internal review in the DON, the NAVAUDSVC opined that:

"While our audit reviews did not identify the reason for non-compliance with these policies (SECNAVINST 7510.8), it is reasonable to believe that it is due to a local commands decision that the billets or resources that would be required to expand or establish an internal review program are not justified. This may be due to a failure of the command to understand or appreciate the benefits that an effective internal review program can accomplish. This would indicate a need to provide convincing evidence to local commanders on the benefits of an effective internal review program."

[9:3]

The author concurs with this opinion and submits that this "education" of local commanders must be the first substantive task in implementing the recommended alternative in the DON. In addition, the DON must support the local commander by assisting in the determination and provision of a sufficient competent internal review staff. In the author's opinion, the current DON policy as stated in SECNAVINST 7510.8 of providing for internal review resources from within available resources, is not conducive to the establishment or expansion of the internal review function, to say the least.

In a time of shortages of both personnel and fiscal resources, it is logical that many local commanders would decide in a rational manner that the billets required for an internal review staff function were simply not justified; given the fact that they must come from some other operationally oriented area within the local command which is possibly already short of personnel. It must be a task of higher echelons, even to the departmental level, to assist the local commander in both determining the number and type of billets required; and securing personnel to fill these billets from outside the local command.

Thus support of the local commander in a tangible manner by higher authority, would serve in the author's

opinion, to provide a conducive foundation for the development of an effective internal review function. It would cement the emphasis being placed in the program.

Once the foundation has been laid, the execution of the secondary responsibilities discussed in the previous section would result, in the author's opinion, in the education by example of local commanders as to the benefits to be derived from an effective internal review function.

One of the important aspects of implementing any new "system," is ensuring that the personnel selected are properly qualified and trained. To this end, the author proposes that all cadre internal review personnel assigned to an internal review function in the DON should be professional auditors, as is the case in the DA. Going a step further, the author recommends that a basic internal review curriculum be developed from the available training courses; and that cadre internal review personnel be required to complete the basic course within a certain time period (for argument's sake, one year) after appointment. Appendix B provides a partial list of the courses of instruction currently available.

The curriculum could be tailored if necessary; and could even be a centrally managed DOD-wide program such as the Defense Procurement Management Courses conducted by the Army Logistics Management Center. On the other

hand, such a curriculum might be instituted at an existing DON educational institution in much the same manner as the Practical Comptrollership Course conducted at the Naval Postgraduate School.

In whatever form, the author feels that a mandatory training program administered and even funded from the department level is necessary to ensure professional internal review personnel are qualified and properly trained. Requiring local commanders to administer and fund professional audit/financial training in an era of "tight money;" is risking the same results as indicated in the NAVAUDSVC and Task Force reports - little or no training. [9:C], [11:136]

The author also recommends that a policy of continuing Professional education be developed along much the same lines as that required for Certified Public Accountants (CPA) in the private sector. As a CPA licensed to practice in the State of Louisiana, the author is required to participate in at least 120 hours of continuing professional education every three years in order to retain licensee status. This requirement equates to approximately one week per year, and hardly seems excessive.

In summary, the status of the internal review function in the DON presented in Chapter III, showed it to be marginally effective in some areas, and ineffective in

others. The author's proposal for a hierarchical internal review system in the DON could be implemented from the existing decentralized system without too many substantial changes or disruptions. The crux of the matter is the proper education of local commanders; and the initial and continuing support of these local commanders by higher authority, concerning the recruitment and training of qualified cadre personnel.

The hierarchical structure would tend to ascertain those local commands without an internal review function which needed one; and would serve as stable professional force for established internal review functions.

A mandatory centrally managed and funded professional training program would tend to provide the local commander with knowledgeable and professional personnel who, in turn, would provide the local commander with tangible evidence of the benefits to be derived from an effective internal review program.

E. SUMMARY

This chapter has provided the reader with the author's proposals for defining and implementing a hierarchical internal review function in the DON. These proposals were based on literary research and subjective analysis of the internal review function in the DON. The specific recommendations made narratively in this chapter are briefly stated below:

1. Internal review in the DON should be a function primarily serving and reporting to the local commander, with some defined secondary responsibility to higher management.
2. The internal review function should be locally organized in a direct staff relationship to the local commander.
3. The internal review function should be delagated the authority, and tasked with managing, all local audit boards.
4. Departmentally, the internal review function should be hierarchically tiered according to the existing line organization, with overall management responsibility emanating from NAVCOMPT.
5. NAVAUDSVC should retain audit responsibility; and the responsibility for developing specialized audit programs for use by the internal review function.
6. The secondary responsibilities of internal review should be limited to professional issues or the provision of basic management information.
7. Any reviews of lower echelon internal review functions by higher echelon functions should be limited to the review of the local internal review function itself, not of the local command.
8. The education of local commanders as to the benefits to be gained from an effective internal review function should receive first priority in the implementation of the new "system."
9. The DON policy regarding the provision of internal review assets from within existing personnel resources should be modified to one of using existing assets whenever feasible; but of providing aggressive support to local commanders in acquiring personnel from outside the command whenever necessary.
10. A mandatory and centrally managed professional training program should be established using existing courses as the core.

11. A program of continuing professional education should be developed and implemented in concert with the basic professional training.

12. Professional training costs should be borne by the central administration if possible, to avoid repetition of past "trade-offs" when an austere funding climate exists.

As a final summary, the author has chosen the following excerpt by Victor Z. Brink which has been paraphrased and edited into a DON context: [15:35]

It is in, indeed, a time for thoughtful and soundly determined action.

Internal reviewers occupy a strategic position. Possessing the special, technical competence in the basic areas of internal control and having been indoctrinated in the broader areas of effective managerial results, they are especially well equipped to make a major contribution.

There is a need for all interested parties to better understand the breadth of the services which can be provided by internal reviewers and to assure that broader utilization. In this context, internal reviewers also have a responsibility to convey that needed understanding, in the interest of their profession and in the interest of the DON as a whole. Internal reviewers must take major steps to prepare themselves to adequately discharge a greater range and higher levels of service.

Altogether, this means new opportunities and further professional growth and development for internal reviewers.

If the time has come for internal reviewers, one hopes they will do everything possible to develop the capabilities to properly utilize the expanding opportunities. . And in all of their endeavors, internal reviewers will need the understanding and support of everyone involved.

APPENDIX A

INTERNAL REVIEW IN THE U.S. MARINE CORPS - SURVEY QUESTIONNAIRE

Questions	Remarks
1. <u>Staffing</u>	
a. Are sufficient personnel assigned to accomplish the intent of internal review? (SECNAVINST 7510.8)	
b. Do assigned personnel have the necessary technical qualifications? (SECNAVINST 7510.8)	
c. Do the working papers reflect the necessary technical competence? (Pomeranz-96)	
d. Is adequate training provided on a continuing basis? (SECNAVINST 7510.8)	
e. Is adequate supervision provided? (SECNAVINST 7510.8)	
2. <u>Organization</u>	
a. Is internal review authorized in a local regulation? (Pomeranz-94)	
b. Does internal review have its own budget? (Pomeranz-94)	
c. Have steps been taken to avoid intentional duplication with NAVAUDSVC activities? (SECNAVINST 7510.8)	
d. Does the internal review staff have complete independence in order to make recommendations free of pressures from other management personnel? (SECNAVINST 7510.8)	

Questions	Remarks
3. <u>Work Performance</u>	
a. Is there an annual internal review program that ensures scheduling of those areas of mandatory and traditional audit coverage and allows for operational studies and reviews especially in areas that may lend themselves to fraud or waste? (NAS-32)	
b. Is the audit coverage of functional areas performed by internal review satisfactory? (NAS-32)	
c. Does internal review accomplish the required audit liaison and follow-up actions? (MCO 7540.2A)	
d. Are internal reviews performed properly? (MCO 7540.2A)	
e. Do the working papers properly document the reviews? (MCO 7540.2A)	
f. Are internal review programs and objectives revised to reflect changing conditions? (Pomeranz-97)	
g. Are internal review activities directed toward appropriate projects, rather than clerical tasks? (Pomeranz-97)	
h. Does internal review provide orientation training on the provisions of R.S. 3679 to newly assigned personnel who will be dealing with appropriated funds? (MCO 7540.2A)	
4. <u>Reporting</u>	
a. Are internal review findings and recommendations reported to the Commander properly? (MCO 7540.2A)	
b. Does the Commander get involved in correction of reported deficiencies? (MCO 7540.2A)	
c. Does internal review enjoy the support and acceptance of the Commander? (Sawyer-23)	

Questions	Remarks
d. Are findings dollarized where practical? (Pomeranz-100)	
e. Are findings usually accepted? (Pomeranz-100)	
f. Are recommendations usually accepted? (Pomeranz-100)	
g. Do internal review reports require a written response by the reviewee? (Pomeranz- 100)	
h. Are reports followed up as to whether deficiencies are corrected and recommendations considered? (Pomeranz-100)	

- REF: (1) SECNAVINST 7510.8, Internal Review in the
Department of the Navy.
- (2) MCO 7540.2A, Internal Review.
- (3) (NAS) NAVAUDSVC Notice 7500, Audit Program
Series.
- (4) Pomeranz, and others, Auditing in the Public
Sector, Warren, Gorham and Lamont, 1976.
- (5) Sawyer, L. B., The Practice of Modern Internal
Auditing, The Institute of Internal Auditors,
Inc., 1973.

APPENDIX B

INTERNAL REVIEW TRAINING COURSES

<u>Course Sponsor</u>	<u>Course Title</u>	<u>Location</u>
NAVCOMPT <u>1</u> /	Financial Management Training Program	Various
IATC <u>2</u> /	Developing and Presenting Audit Findings	Various
IATC	Effective Governmental Auditing	Various
IATC	Interviewing Techniques For Auditors	Various
IATC	Operational Auditing	Various
IATC	Practical Statistical Sampling for Auditors	Various
IATC	Planning, Managing, and Reporting for Audit Managers/Supervisors	Various
IATC	Successful Audit Report Writing	Various
IATC	Auditing Systems Supported By ADP Equipment I	Various
IATC	Auditing Systems Supported By ADP Equipment II	Various
IATC	Written Communications for Auditors	Various
IATC	Seminar for Audit Managers	Various
NAVEDTRA <u>3</u> /	Financial Management In the Navy	Correspondence
NAVEDTRA	Appropriation and Cost Accounting	Correspondence

<u>Course Sponsor</u>	<u>Course Title</u>	<u>Location</u>
NAVEDTRA	Navy Public Works Management	Correspondence
NAVEDTRA	Navy Supply Systems	Correspondence
NAVEDTRA	Supply Ashore	Correspondence
NAVEDTRA	Storage and Materials Handling	Correspondence
NAVEDTRA	Navy Food Service Management	Correspondence
ALMC <u>3/</u>	Defense Procurement Management Course	Correspondence
ALMC	Defense Small Purchase Course	Correspondence

- 1/ Comptroller of the Navy course description, dates, and location can be obtained from the Naval Accounting and Finance Center (Code NAFC-5), Room 401, Crystal Mall 3, Washington, D.C. 20390. Autovon 225-2708
- 2/ Inter-agency Auditor Training Center course descriptions, dates, and locations can be found in the IATC catalog. Copies can be obtained from IATC, 8120 Woodmont Avenue, Room 607, Bethesda, MD 22014
- 3/ Chief of Naval Education and Training/Army Logistics Management Center course descriptions and information can be obtained from the List of Training Manuals and Correspondence Courses, NAVEDTRA 10061-AL. Copies should be available from the command training office or can be ordered from the Navy Publications and Forms Center, Philadelphia, PA 19120, Stock No. 0502-LP-050-3090.

LIST OF REFERENCES

1. Major Michael E. Thorn, USAF; "Productivity;" "Armed Forces Comptroller;" volume 25, number 4; ASMC 4110 Robertson Blvd., Alexandria, VA 22309; November, 1980.
2. Robert C. Moot; "Remarks to the National Symposium of the American Society of Military Comptrollers, 23 May 1980; "Armed Forces Comptroller," volume 25, number 4; ASMC, 4110 Robertson Blvd., Alexandria, VA 22309; November, 1980.
3. Cordell Smithfield; Speech; "Armed Forces Comptroller;" volume 25, number 1; ASMC, 4110 Robertson Blvd., Alexandria, VA 22309; February, 1980.
4. Hon. Jack B. Brooks, "Remarks of Congressman Brooks Before the Washington Chapter of ASMC on Sept. 25, 1979." Speech. American Society of Military Comptrollers, Washington, D.C.: 25 September 1979.
5. Fred A. Dramer, Contemporary Approaches to Public Budgeting; Winthrop Publishers, Inc., Cambridge, Massachusetts; 1979.
6. Naval Postgraduate School, Monterey, California; "Practical Comptrollership Course Student Text;" - Second Edition; December, 1979.
7. Dennis S. Ippolito; The Budget and National Politics; W. H. Freeman and Company, San Francisco, CA; 1978.
8. Robert N. Anthony and Regina E. Herzlinger; Management Control in Nonprofit Organizations, revised edition; Richard D. Irwin, Inc., Homewood, Illinois; 1980.
9. Auditor General of the Navy letter 0-24, 7500 dated 13 March 1980; Subject: "Navy's Internal Review Program," with enclosure.
10. Secretary of the Navy Instruction 7510.8 dated 15 October 1975; Subject: "Internal Review in the Department of the Navy."

11. The Task Force on Evaluation of Audit, Inspection and Investigative Components of the Department of Defense: "The Department of Defense and the Inspector General Act of 1978, a Report to the Congress and the Secretary of Defense;" 1 May 1980.
12. Sawyer, L. B., "Internal Auditing Yesterday, Today and Tomorrow," Internal Auditor, V36, N6, Dec. 79.
13. Schick, A.; "200 Years of Financial Management;" Armed Forces Comptroller, V21, N3, July 1976.
14. Comptroller General of the United States Report B-198550, GAO Findings on Federal Internal Audit, May 27, 1980.
15. Brink, V. Z., "Internal Auditing: A Historical Perspective and Future Directions, Internal Auditor, V35, N 36, Dec. 78.
16. Robertson, J. C., Auditing, revised edition, Business Publications, 1979.
17. Comptroller General of the United States, Standards for Audit of Governmental Organizations, Programs, Activities and Functions; General Accounting Office; 1972.
18. Meigs, W. B. PH.D., CPA and Larson, E. J., D.B.A., CPA; Principles of Auditing, fourth edition, Irwin, 1969.
19. Naval Education and Training Command, Financial Management in the Navy, NAVEDTRA 10792-D, Washington: 1974.
20. Baggette, J. C., A Survey of Internal Review in the U.S. Marine Corps, MS Thesis, Naval Postgraduate School, Monterey, 1980.
21. Office of the Secretary of the Navy, "Department of the Navy Audit Manual for Management," (U) SECNAVINST 7510.7A, Washington, 28 December 1978.
22. Office of the Comptroller of the Navy, Introduction to Navy Audit and Internal Review, Washington: 1979.
23. Webster's New Collegiate Dictionary. 1977 edition, Merriam-Webster, 1977.

24. Allison, G. T., "Conceptual Models and the Cuban Missile Crisis." "Essence of Decision: Explaining the Cuban Missile Crisis," Boston: Little, Brown, 1971.
25. Haffa, R. P., Jr., "Allison's Models: An analytic Approach to Bureaucratic Politics." Handout for MN-3172 "Public Policy Processes," QII, AY80 (Winter 79/80), Naval Postgraduate School, Monterey, Ca., conducted by Assistant Professor Edward J. Laurance and Commander Edwin A. Fincke, SC, USN.
26. McNellen, J. B.; Zand, D. E.; and Lewin, A. Y.; "The Political Model of the Budget Process;" "Armed Forces Comptroller;" Vol. 18, No. 4, Fall 1973.
27. Pomeranz, Felix, et. al., Auditing in the Public Sector, Warren, Gorham & Lamont, New York, 1976.
28. Naval Audit Service, Management Consulting Division, "Internal Review - A Case Study," proposed draft copy, undated, based on FY79 audit experience.
29. Simons, H., M.A., C.P.A. and Karrenbrook, W. E., C.P.A. Intermediate Accounting, fourth edition, South-Western; 1964.
30. Frost, S. D., RADM, USN; open letter to financial managers from the Comptroller of the Navy, dated 24 Nov. 80; Office of the Comptroller of the Navy; "Financial Management Newsletter," NAVSO P-3568, Vol. V, No. 1, winter 1980. Washington, D.C.
31. Task Force on Evaluation of Audit, Inspection and Investigative Components of the Department of Defense, "United States Army Internal Review System," Washington, D.C., 3 December 1979.
32. U.S. General Accounting Office, Financial and General Management Studies Division, "Directory of Federal Audit and Inspector General Organizations," third edition, General Accounting Office, Washington, D.C., April, 1980.
33. Headquarters, U.S. Marine Corps; "Internal Review," MCO 7540.2A, Washington, D.C., 24 September 1979.
34. Isaacson, W.; "America's Incredible Day;" "Time," vol. 117 no. 5; Time, Inc., Los Angeles, 2 February 1981.

35. White, R. H., "Can Government Auditors Be Independent?;" "The Government Accountants Journal," vol. 27 no. 4, winter 1978-1979.
36. Naval Audit Service, "Summary of Results of the Internal Review Audit Emphasis Program," Draft copy, unpublished provided to researcher by Navy Accounting and Finance Center, Washington, D.C.
37. Auditor General of the Navy; "Memorandum for the Assistant Secretary of the Navy (Financial Management);" Subject: Report to the Congress and the Secretary of Defense on the Inspector General Act of 1978; reference number OPS 5040 dated 16 June 1980.
38. Webber, R. A.; Management: Basic Elements of Management Organizations; revised edition; Richard D. Irwin, Inc.; 1979.
39. Office of the Comptroller of the Navy, "Memorandum for the Deputy Comptroller of the Navy," subject: Evaluation of Audit, Inspection, and Investigative Components of the DOD; number NCFF-2D 5040 dated 11 Jul 1980.
40. Bobulinski, R. W., LCDR, SC, USN; "Field Level Activity and Internal Review: A Must Combination;" Office of the Comptroller of the Navy; Financial Management Newsletter; NAVSO P-3568, Vol. V, No. 1, Winter, 1980, Washington, D.C.

INITIAL DISTRIBUTION LIST

	No. Copies
1. Defense Technical Information Center Cameron Station Alexandria, Virginia 22314	2
2. Library, Code 0142 Naval Postgraduate School Monterey, California 93940	2
3. Department Chairman, Code 54 Department of Administrative Sciences Naval Postgraduate School Monterey, California 93940	1
4. LCDR Robert A. Bobulinski, Code 54Bb Department of Administrative Sciences Naval Postgraduate School Monterey, California 93940	4
5. Lt. D. D. Lancaster, Jr., SC USN Naval Submarine Support Base Kings Bay, Georgia 31547	1
6. CDR Edwin A. Fincke, Code 54Fi Department of Administrative Sciences Naval Postgraduate School Monterey, California 93940	1
7. Defense Logistics Studies Information Exchange U.S. Army Logistics Management Center Fort Lee, Virginia 23801	1
8. Wayne Adams Naval Audit Service Headquarters Post Office Box 1206 Falls Church, Virginia 22041	1
9. Performance Analysis and Evaluation Division 1 Navy Accounting and Finance Center Washington, D.C. 20350 Attention: CAPT. Paszly	1

No. Copies

10. Chief of Naval Operations (OP-925)
Department of the Navy
Washington, DC 20350
11. Commander
Naval Supply Systems Command (SUP 06)
Washington, DC 20376

1

1

27064

Thesis
L25587
c.1

Lancaster

192339

A historical analysis of internal review.

12 JUN 82

27064

Thesis
L25587
c.1

Lancaster

192339

A historical analysis of internal review.

thesL25587

A historical analysis of internal review



3 2768 002 11309 4

DUDLEY KNOX LIBRARY